
ASIAN MONETARY MONITOR

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KEY TO SYMBOLS USED IN THE CHARTS

% **RP** - Percentage Rate of change over Preceding period.

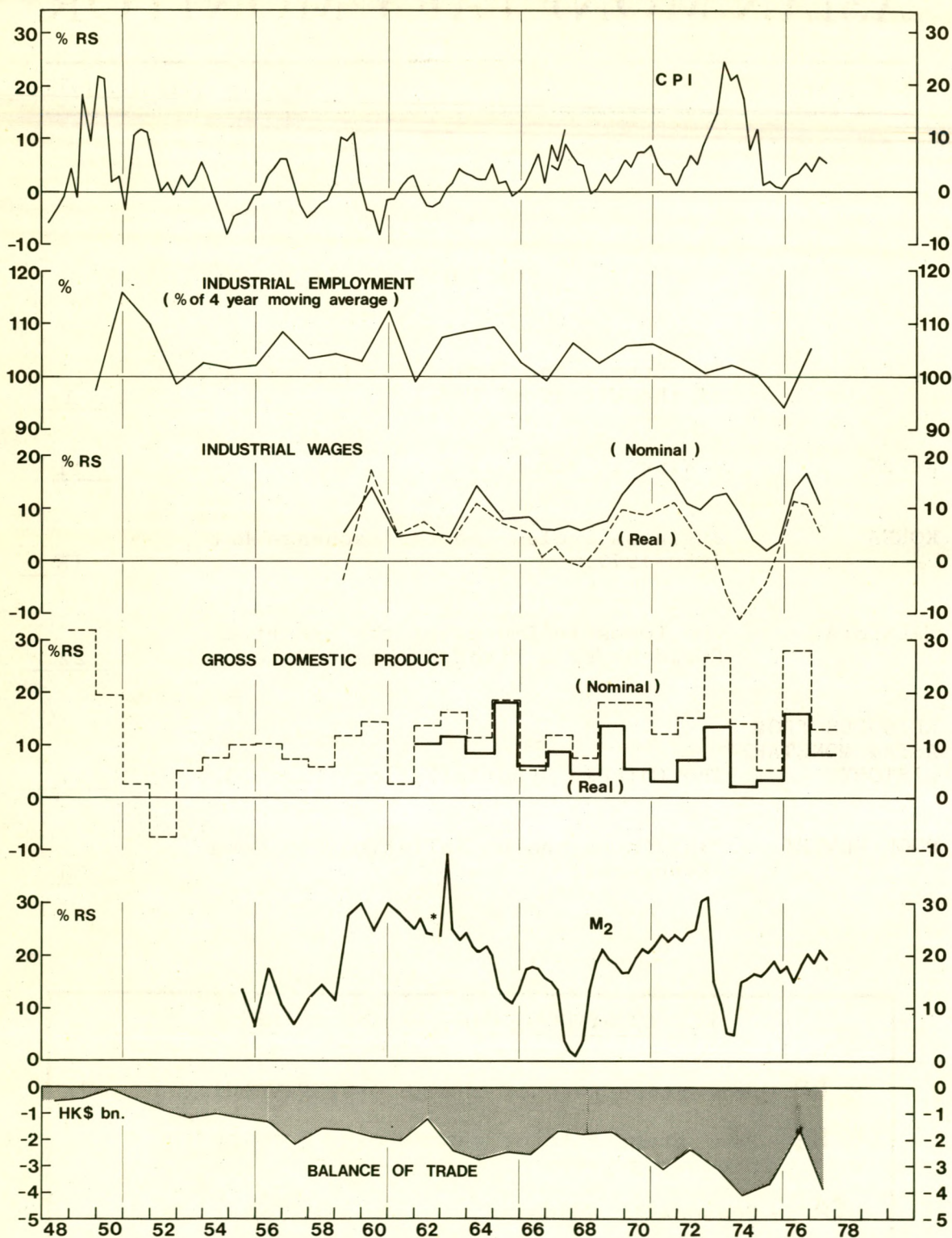
% **RS** - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG

CHART 1 : MAIN ECONOMIC INDICATORS



* Before 1963, total bank deposits only.

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HONG KONG

THE SUPPLY AND DEMAND FOR LABOUR: A TEST OF THE CLASSICAL MODEL.

The flexibility and resourcefulness of Hong Kong industry has been a matter for pride for decades. The rapidity with which manufacturers can respond to changes in world demand for Hong Kong's products has made the colony into a lead indicator of economic activity in other parts of the globe.* Undoubtedly among the factors contributing to this adaptability has been the flexibility of wage rates and the readiness with which the workforce moves to the most productive sectors.

The reasons for this flexibility in the labour market are many. Hong Kong has a low degree of unionization of the workforce; only about 25% of manufacturing sector employees belong to unions and the unions are typically small and lack power. The large refugee population and the relatively recent growth of manufacturing industry have meant that workers do not strongly identify with particular occupations and show a readiness to change jobs in search of higher pay or better conditions. This process has been facilitated by the fact that a high proportion of jobs are relatively unskilled so that most transfers from one job to another do not involve high costs associated with learning new skills. Also the small geographical area of Hong Kong makes it physically possible to change to a job in a new location without incurring costs of moving house. Nor has the adjustment of wage rates been distorted by minimum wage legislation, a strongly redistributive system of taxation, or large scale transfer payments from one group in the economy to another. For all these reasons it is likely that the interaction of supply and demand for labour in Hong Kong resembles more closely than in most other industrial economies the market model in classical economic theory.

One of the conclusions of the classical market model is that the supply and demand for labour are brought into equilibrium by changes in the real wage, rather than by changes in the level of unemployment. As can be seen from Chart 1, the daily wage rates in Hong Kong's industry have varied considerably and in 1973, 1974 and 1975 there were even large declines in real terms. Unfortunately unemployment statistics have only become available in the past few years - an atypical period when the economy has been recovering from a very severe recession - so the hypothesis that unemployment varies little in response to changes in the supply and demand for labour is difficult to test.

In periods of high rates of export growth both the level of employment and wage rates have risen rapidly in response to the increased demand for labour by manufacturers. This occurred for instance in 1969 and 1975-6. The growth of foreign demand for Hong Kong's products in 1975 led to an unprecedented acceleration in exports and a significant shift in the demand for labour by

* see Asian Monetary Monitor Vol.1 No.1

the manufacturing sector. Wages were bid up and employment in that sector rose rapidly, nevertheless an acute labour shortage occurred. The ratio of vacancies to employment in manufacturing for example jumped from 1.4% to 5.7% in the six months to March 1976 while real wages rose 9.2% in the same period.

The rapid rise in manufacturing wages relative to wages in other sectors attracted an increased supply of labour to manufacturing with the result that employment in manufacturing grew 11.3% in the same six months and by a further 7.2% in the next three months to June. At this stage the slight lag between wage acceleration and the response of the labour force caused the vacancy rate to ease somewhat to 4.4%. As exports levelled off and then began to decline towards the end of 1976 the demand for labour probably slackened and both the vacancy rate and the rate of growth of wages might have been expected to decline, but by then a new source of demand had appeared in the labour market.

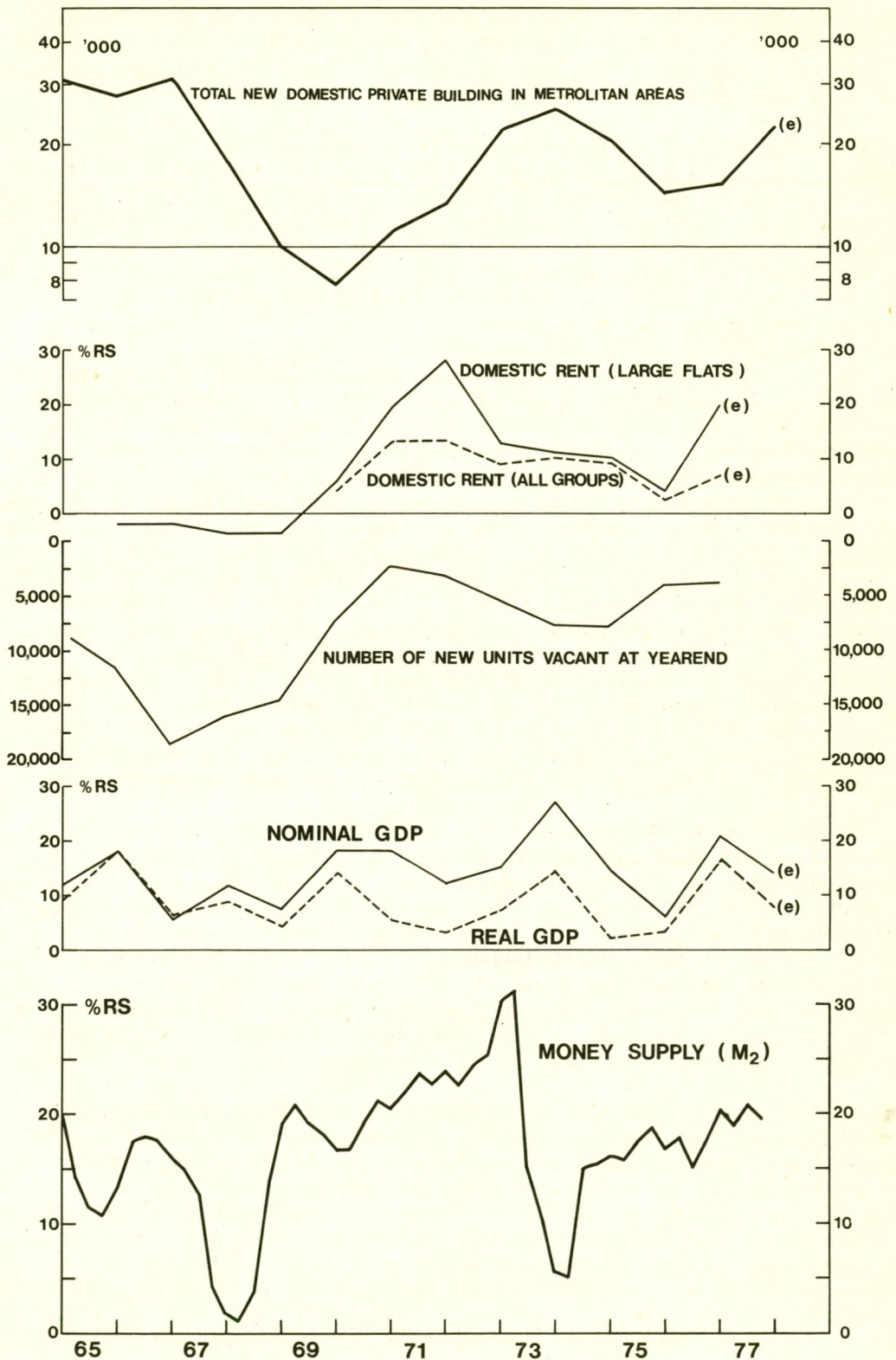
The combination of low interest rates and a rapid increase in real incomes at the end of 1975 (after nearly 2 years during which real income had been falling) was an ideal recipe to stimulate demand for private accommodation (Chart 2). Starting in 1975 activity in the private building sector recovered quickly, so that in 1976 private construction expenditure grew 42% in real terms - the highest rate since 1963. Simultaneously several public construction schemes got under way including the Mass Transit Railway project so that by the end of 1976 the construction sector began to bid more aggressively for labour, a phenomenon which was reflected in the differential movement of wage rates between construction and other sectors.

Real wages in the construction sector had not risen at all in the year to March 1976 while real manufacturing wages had risen 12 $\frac{1}{2}$ %, but in the subsequent 12 months construction sector wages took the lead growing 10.8% in real terms compared with only 4.7% in manufacturing, and employment in the construction sector grew by nearly a third. Not only was the manufacturing sector facing stiffer competition for workers but also the size of the total available workforce was contracting. This can be attributed to the 'backward sloping supply curve' phenomenon: as real family incomes rose the need for so many members of the family to work was reduced so that even though demographically the size of the potential labour force was growing rapidly, the number in employment or seeking work declined.*

The contraction in the size of the labour force and increasing competition from other sectors in the economy meant that even though a large fall in exports reduced the demand for labour the manufacturing sector was still short of workers. How much the shortage was due to the tightening of supply of labour to manufacturing and how much could be attributed to the structural change in the composition of the demand for labour (for instance, the

* The size of the labour force, i.e., the number of employed and officially unemployed fell from 1,982,000 in September 1975 to 1,918,000 in September 1976 and 10,000 women left the workforce between March 1976 and March 1977.

HONG KONG
CHART 2 : MONEY, GROSS DOMESTIC PRODUCT, AND THE PROPERTY MARKET



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increasing demand for skilled as opposed to unskilled labour) cannot be ascertained from the available data. Nevertheless, the vacancy ratio rose in the second half of 1976 despite an absolute decline in exports, a fall in Orders-on-Hand, and wage increases of 12% in the year to March 1977.

The implications for the profits of the manufacturing sector over this period are worth considering. In the first half of 1977 domestic exports had risen 7% in value compared with a year before, and imports of raw materials and semi-manufactured goods had also risen 7% but the total labour costs are estimated to have risen by over 20%.* Although too much significance should not be placed on these figures they do indicate that manufacturers' profit margins were reduced.

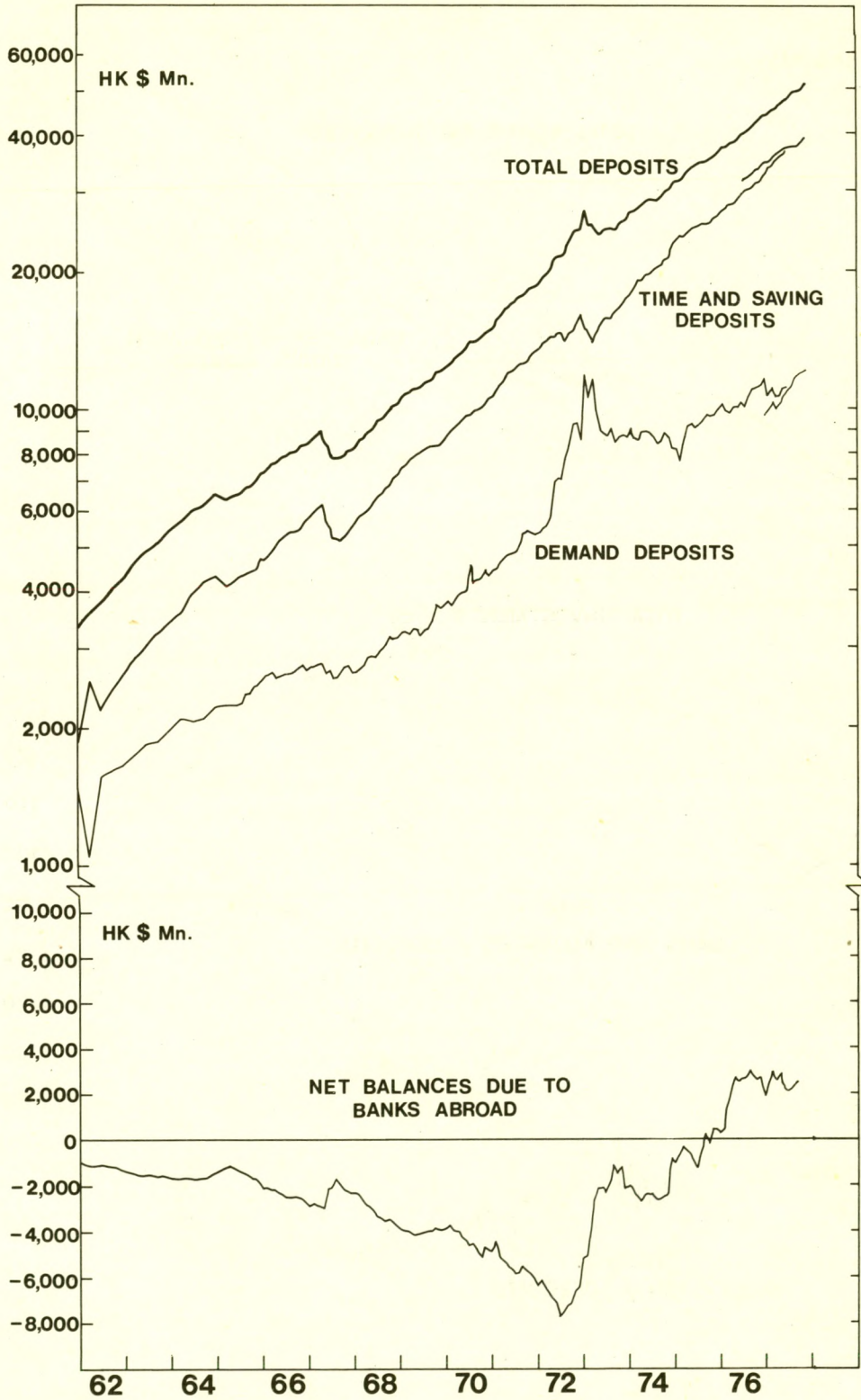
At the end 1976 the Hong Kong dollar appreciated quite sharply against the US currency - probably reflecting the improvement in Hong Kong's balance of trade, and in early 1977 there was a widespread belief that because the Hong Kong dollar was overvalued the competitiveness of Hong Kong exports was suffering as a result. Our purchasing power parity analysis of the exchange rate (see Asian Monetary Monitor Vol.1 No.1) indicates that the Hong Kong dollar was not overvalued in early 1977 and that manufacturers did not have any grounds for implicitly blaming currency speculators for the decline in export orders. It was probably the labour shortage and the resultant increase in labour costs which was the cause of the manufacturers' discontent. Nevertheless, the cuts in interest rates on January 8th and April 14th 1977 were made explicitly to reduce upward pressure on the exchange rate, by discouraging capital inflows. The subsequent weakening of the Hong Kong dollar may have been in part due to the cut in interest rates but also probably reflected a deterioration in the balance of payments.

In the 1960s there was some connection between the balance of payments and the growth of the money supply (Chart 1). However this relationship had been weakening, and in the past few years the correlation between changes in the Money Supply and changes in the balance of trade has been poor. Despite the sharp deterioration in the trade balance in 1977 and the probable deterioration in the balance of payments and the foreign reserves of the banking system, monetary growth has continued unabated and even accelerated slightly. This no doubt helped sustain private consumption demand and the level of prices in property market.

If the growth in the money supply had been restricted to some degree by the deterioration in balance of payments, the rate of growth of nominal GNP would have been slower. The increase in wage costs would have bitten more deeply into profits and interest rates would have risen earlier than they did. The constraint on the growth of GNP imposed by the slowdown in monetary growth would have dampened domestic demand and the labour shortage would have eased. In this way the much vaunted 'automatic stabilizer' would have brought the level of domestic activity into line with the level of exports bringing the balance of payments back into equilibrium.

* employment rose 8.2% and average daily wage rates rose 12.1% in the year to March 1977.

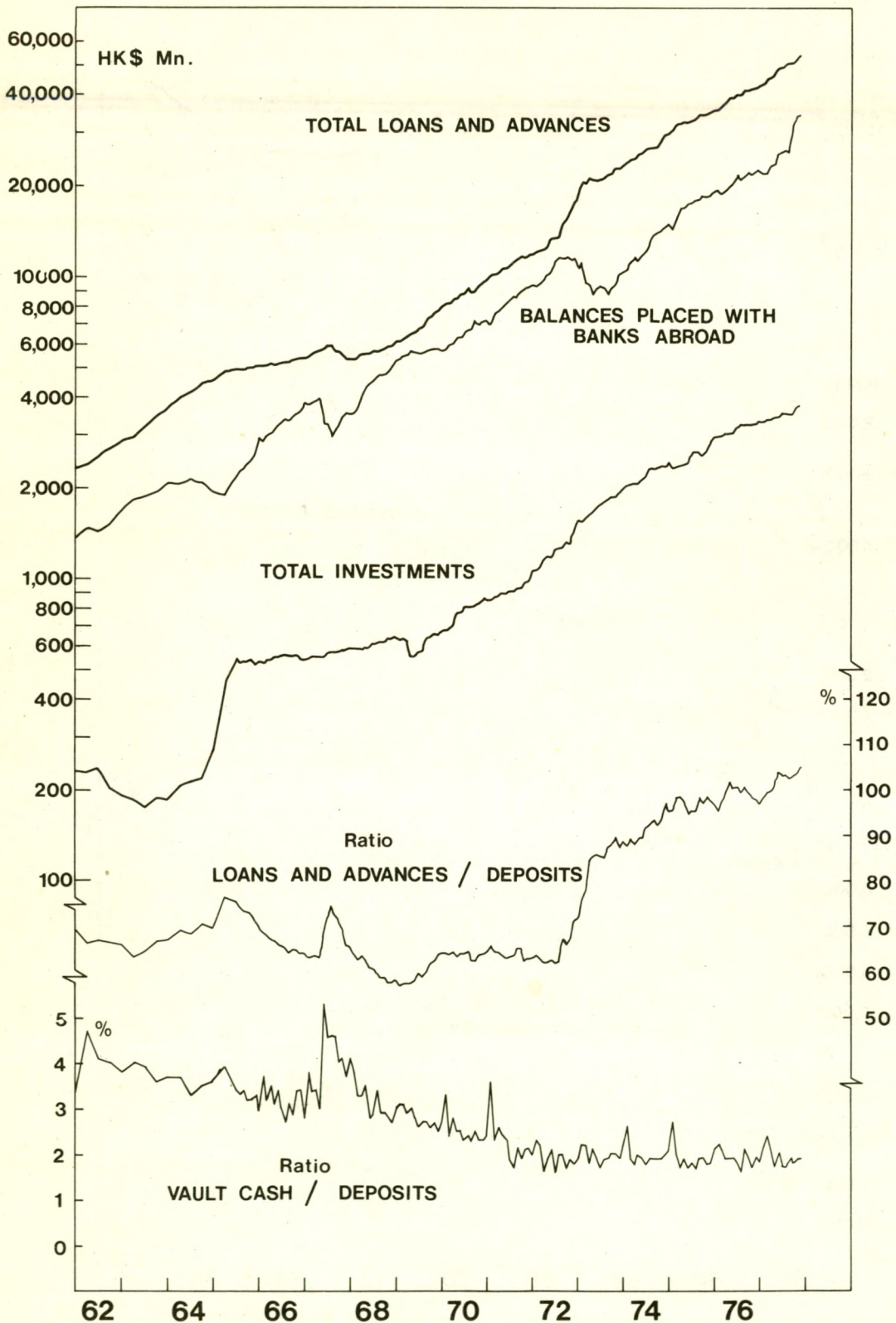
HONG KONG
CHART 3 : BANK LIABILITIES



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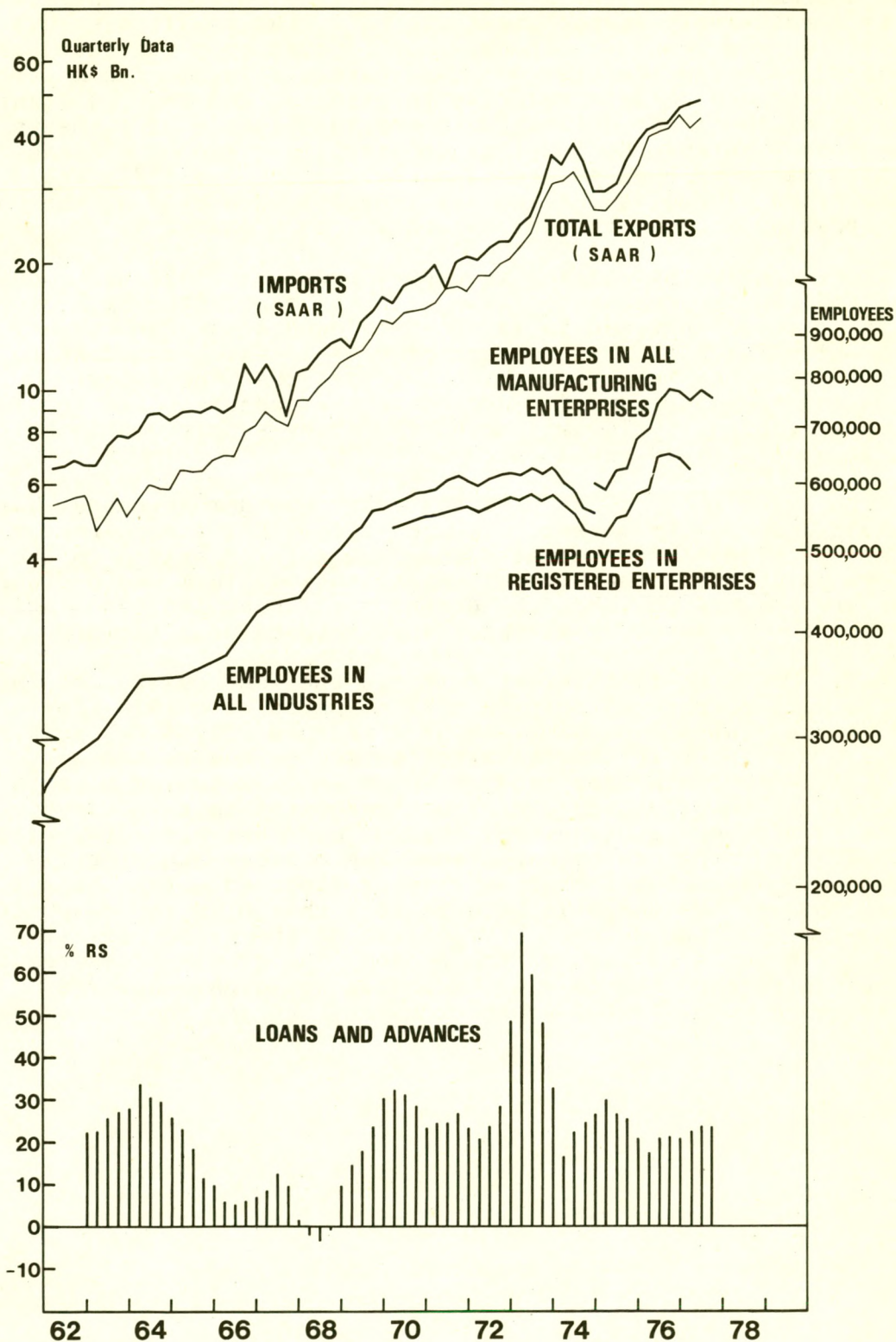
HONG KONG

CHART 4 : BANK ASSETS



HONG KONG

CHART 5 : BANK LOANS, EMPLOYMENT, AND EXTERNAL TRADE



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As it was, the monetary ease enabled the rise in wage costs to be accommodated not by a severe reduction in profit margins but by a relatively faster growth in GNP. The result was that domestic demand remained strong, the property boom continued and the labour shortage persisted. The sustained level of domestic demand increased imports relative to exports, and the resultant widening of the trade deficit weakened the balance of payments. In consequence the Hong Kong dollar declined in value on a trade-weighted basis by 5.9% between January and October 1977. The preservation of profit margins was therefore achieved at the cost of increasing inflationary pressures in the economy.

Fortunately the decline in export orders in 1977 has considerably reduced the demand for labour in the manufacturing sector, and the rate of increase in wages has slowed down. The vacancy ratio which reached a record high of 6.4% in March was down to 4.8% by September last year which suggests that the labour shortage has eased. However domestic demand in the economy could remain at its present high levels as long as the money supply continues to grow at a relatively rapid rate.

The experience of the past few years has demonstrated that the Hong Kong labour market does show several of the characteristics of the classical market model. The labour force shifts to the sectors which offer the highest wages and away from sectors where wages are low. Also, when the demand for labour increases sharply relative to the supply real wages appear to respond rapidly.

FORECAST: The rise in interest rates in the last quarter of 1977 and the larger trade deficit in 1977 compared with 1976 are indications that the economy may have reached a cyclical peak. The shortage of labour in the construction sector contrasted with the decline in demand for labour in some manufacturing sectors particularly textiles and clothing - indicates that the labour market is undergoing structural changes and that wide disparities between wage rates can be expected. The economy therefore is experiencing structural changes which reflect both the shift in demand towards the domestic sector and a change in the composition of exports. As the deflationary effect of the trade deficit gradually percolates through the economy the growth of aggregate demand can be expected to slow, and this would have adverse implications both for the property market and for the equity market.

A KINK IN MARSHALL k ?

The modern quantity theory of money or monetarist hypothesis is that inflation is "always and everywhere a monetary phenomenon", caused by excess growth of the money supply in relation to the growth in the volume of output. By extension, the only exceptions to this generalisation are general price rises resulting from (a) an independent change in the income velocity of circulation and (b) an independent decline in the volume of output.* The validity of the hypothesis hinges critically on what has been called the "functional stability" of income velocity, that is to say the hypothesis that if there are changes in the level or trend of income velocity, those changes can themselves be explained by changes in the determinants of income velocity. The evidence collected for every country where these relationships have been rigorously tested tends to support the modern quantity theory. The conclusion is that income velocity is "functionally stable", and it follows, therefore, that the choice of an appropriate rate of monetary growth is essential to the maintenance of long term price stability. A crucial element in that selection concerns the analysis and prediction of the rate of change of income velocity. In November 1977 the Research Department of the Bank of Japan published a study (in Japanese) of the trend in Marshall k (i.e. the reciprocal of income velocity), together with a supplementary paper on the statistical results of estimating the demand-for-money function in Japan.** Future issues of Asian Monetary Monitor will provide a critique of this analysis; in the current issue we offer a translation of the Summary of this important study.

"THE UPWARD TREND OF MARSHALL K IN JAPAN"

SUMMARY

The relationship between the level of real economic activity and the money supply may be studied by observation of Marshall k, defined as the ratio of cash currency plus deposits to nominal GNP. Since the mid-1950s this ratio has followed an upward trend, and, despite some differences in the gradient of the slope, this is in accord with the experience of other nations. In the Japanese case the upward trend was particularly pronounced, though since 1965 it has been refracted or kinked towards a more horizontal trend (see Chart 1).

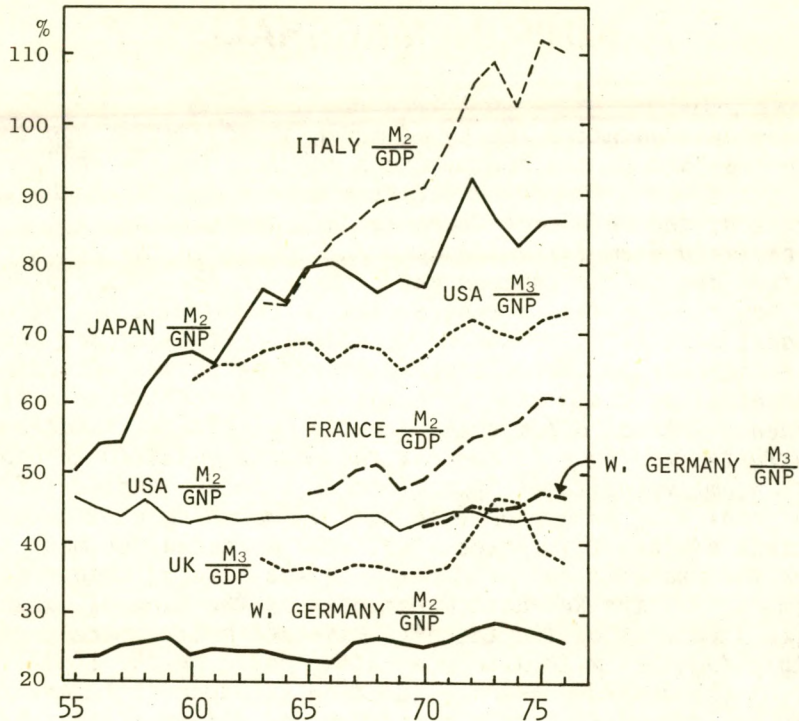
2. If the trend of Japan's Marshall k ratio is analysed in terms of the personal and corporate business sectors, Marshall k for the personal sector shows a persistent upward trend (See Chart 2). The background to this phenomenon is to be found in the very strong rise in real income during the period of rapid economic growth (Kōdōseichō), and more recently in the abnormal rise in the savings

* Examples of the first exception are to be found in the experience of the United States and Japan following the outbreak of the Korean War. An example of the second exception is the drastic decline in production in Japan at the end of World War II.

** Bank of Japan Research Dept., Chōsa Geppō, Shōwa 52-nen, 11-gatsu gō.

CHART 1

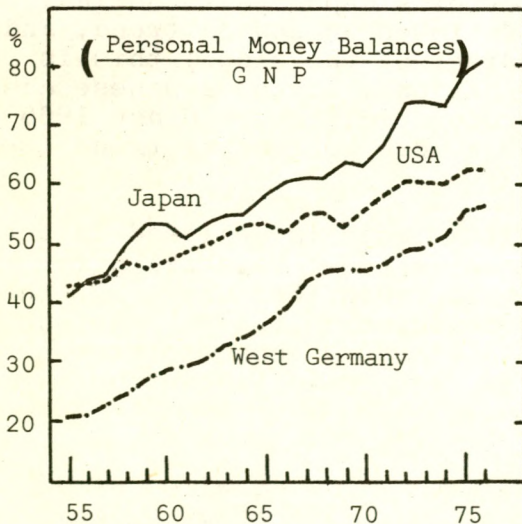
TREND OF MARSHALL K IN MAJOR ECONOMIES



Data: In all cases yearend money data divided by GNP or GDP for that year.

CHART 2

MARSHALL K IN THE PERSONAL SECTOR FOR THREE MAJOR ECONOMIES

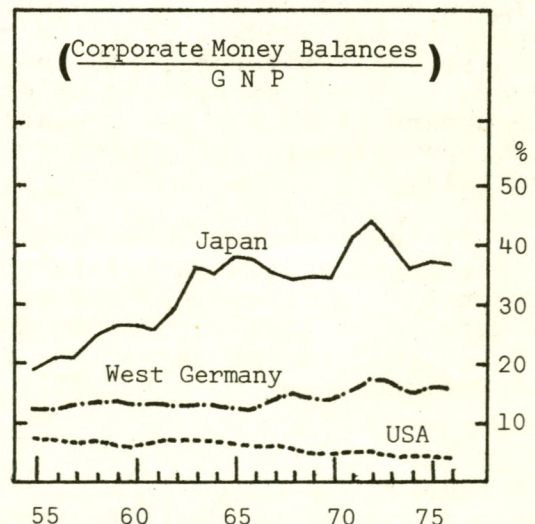


Data: Flow of Funds Tables; all cases yearend money balances for each sector divided by GNP for that year.

Source: Bank of Japan

CHART 3

MARSHALL K IN THE CORPORATE SECTOR FOR THREE MAJOR ECONOMIES



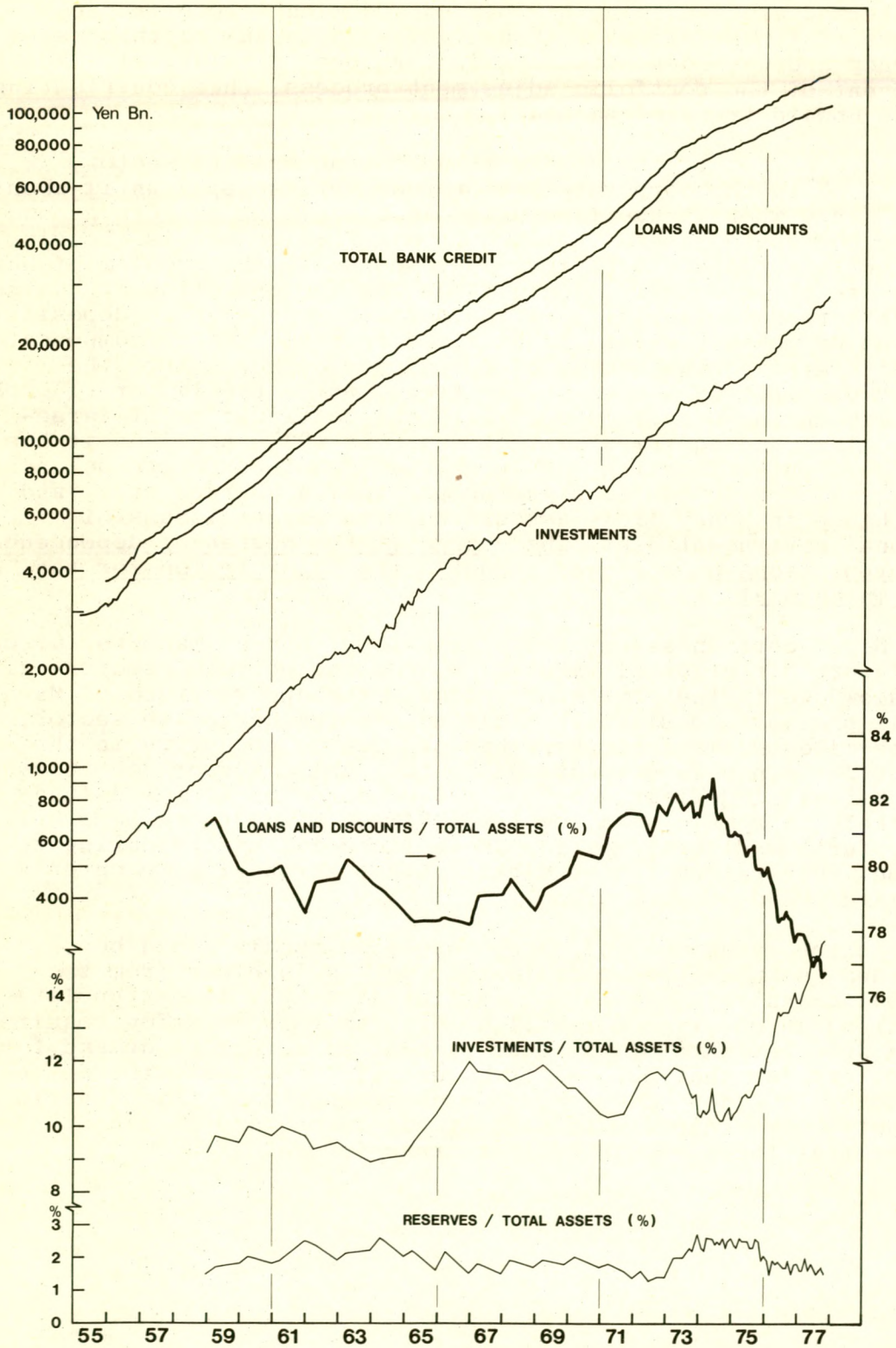
rate in the face of uncertainty about the future. Also, indirect or intermediary financing has played a dominant role in the process of financial asset accumulation in Japan, so that cash currency and bank deposits have in turn been a relatively important component of the portfolio adjustment process, thus contributing to the upward trend of Marshall k.

3. In contrast to the upward trend in the private sector, Marshall k in the corporate sector rose very steeply until about 1965, since when it has fluctuated in a cyclical pattern around a more horizontal trend (See Chart 3). This change is closely related to corporate behaviour in response to the problem of how to ensure the necessary liquid funds for the operation of business. If the corporate liquidity ratio (defined as cash plus deposits divided by monthly sales) is examined in terms of the compensatory deposit rate and the degree of dependence on borrowing, the former displays an almost stable trend, while the latter (1) rose strongly in the decade 1955-65 with the continuation of large-scale plant and equipment investment, but (2) since 1965 it has flattened out reflecting the strengthening of corporate balance sheets which accompanied higher depreciation charges etc., and the change in money flows associated with larger issues of national government debt. The change in the degree of dependence of corporations on borrowed funds is the major reason for the kink in Marshall k.

4. Given certain assumptions, an attempt can be made to forecast the future direction of Marshall k. For the personal sector, given the slowdown in the growth of incomes, the upward trend of Marshall k will probably be slightly modified. In the corporate sector, as the mild cyclical recovery has progressed no upturn in the demand for money is evident. While the public sector continues in substantial deficit, corporate dependence on borrowed funds is likely to remain at a low level. Also, since there is likely to be further diversification among financial assets during this period, this raises the possibility that Marshall k may enter a downward trend.

5. In the management of money supply, Marshall k can be regarded as an important indicator, but as is clear from the preceding analysis, it is not sufficient simply to extrapolate the trend in observed Marshall k. Such an extrapolation requires an ex ante estimate of the exact amount of corporate demand for money, and for that purpose it is useful to estimate the demand-for-money function. However, some determinants of this function are not easy to capture in statistical terms, and it cannot be denied that there remain further areas for research.

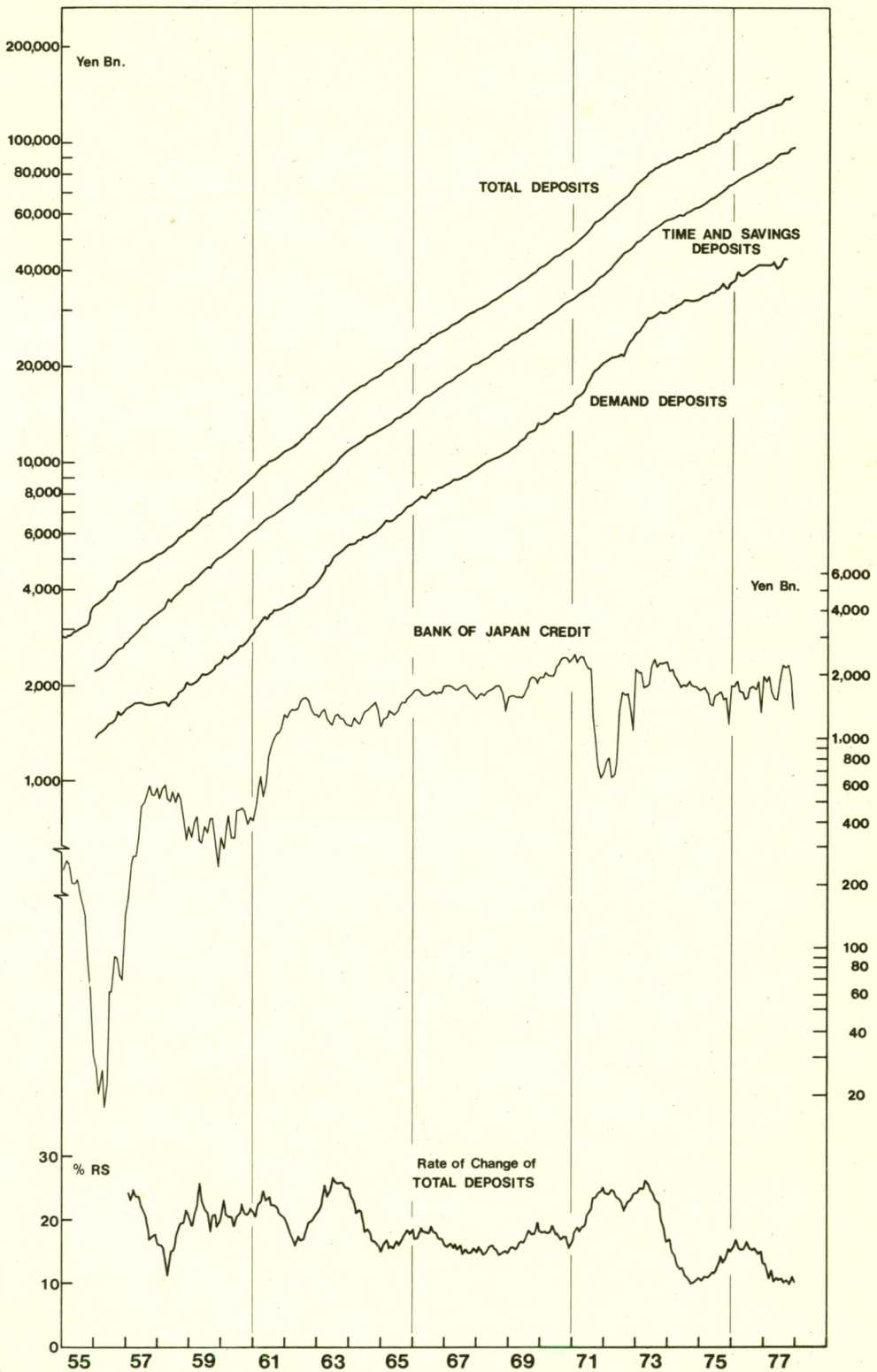
JAPAN
CHART 4 : BANK ASSETS



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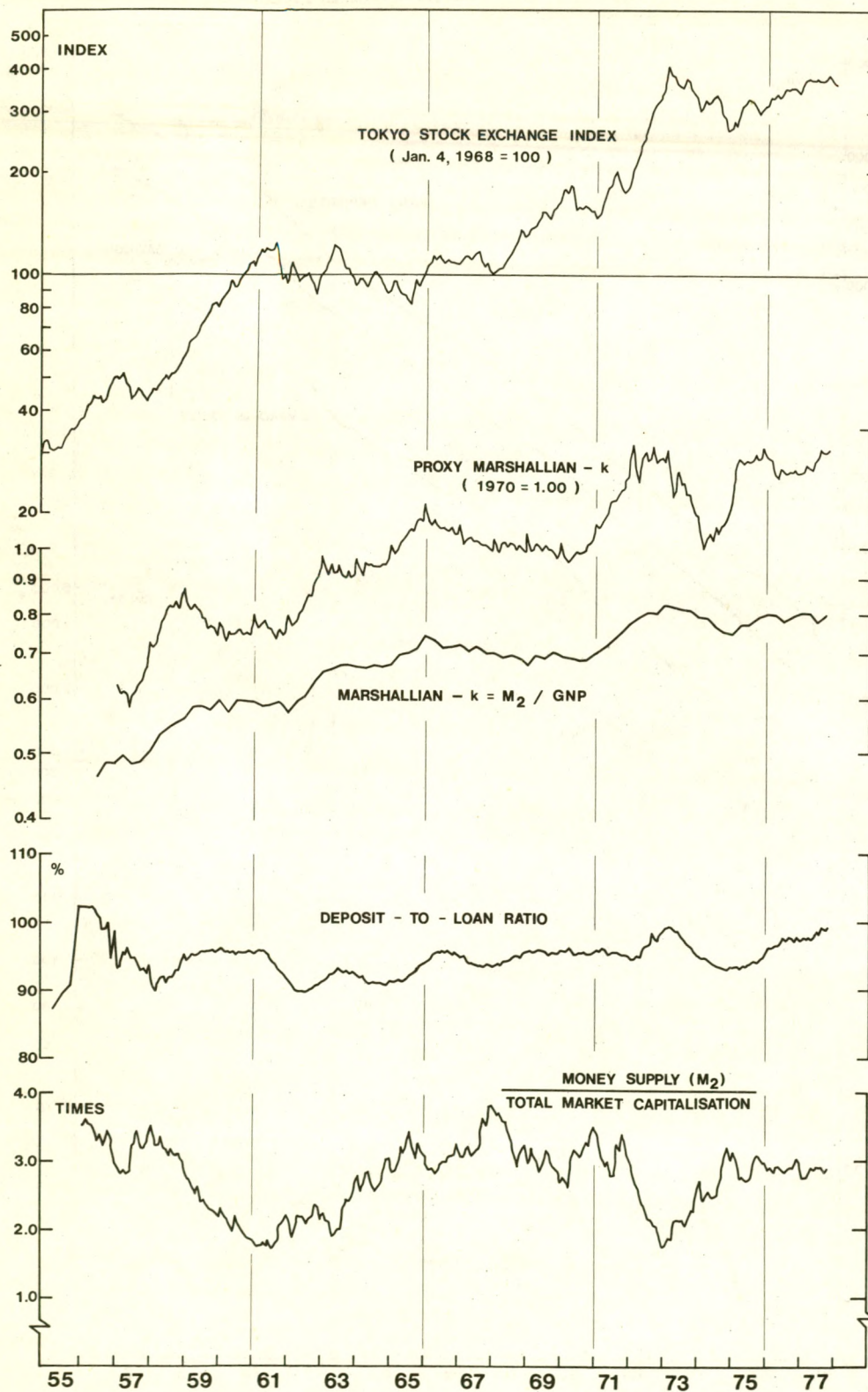
JAPAN

CHART 5 : BANK LIABILITIES



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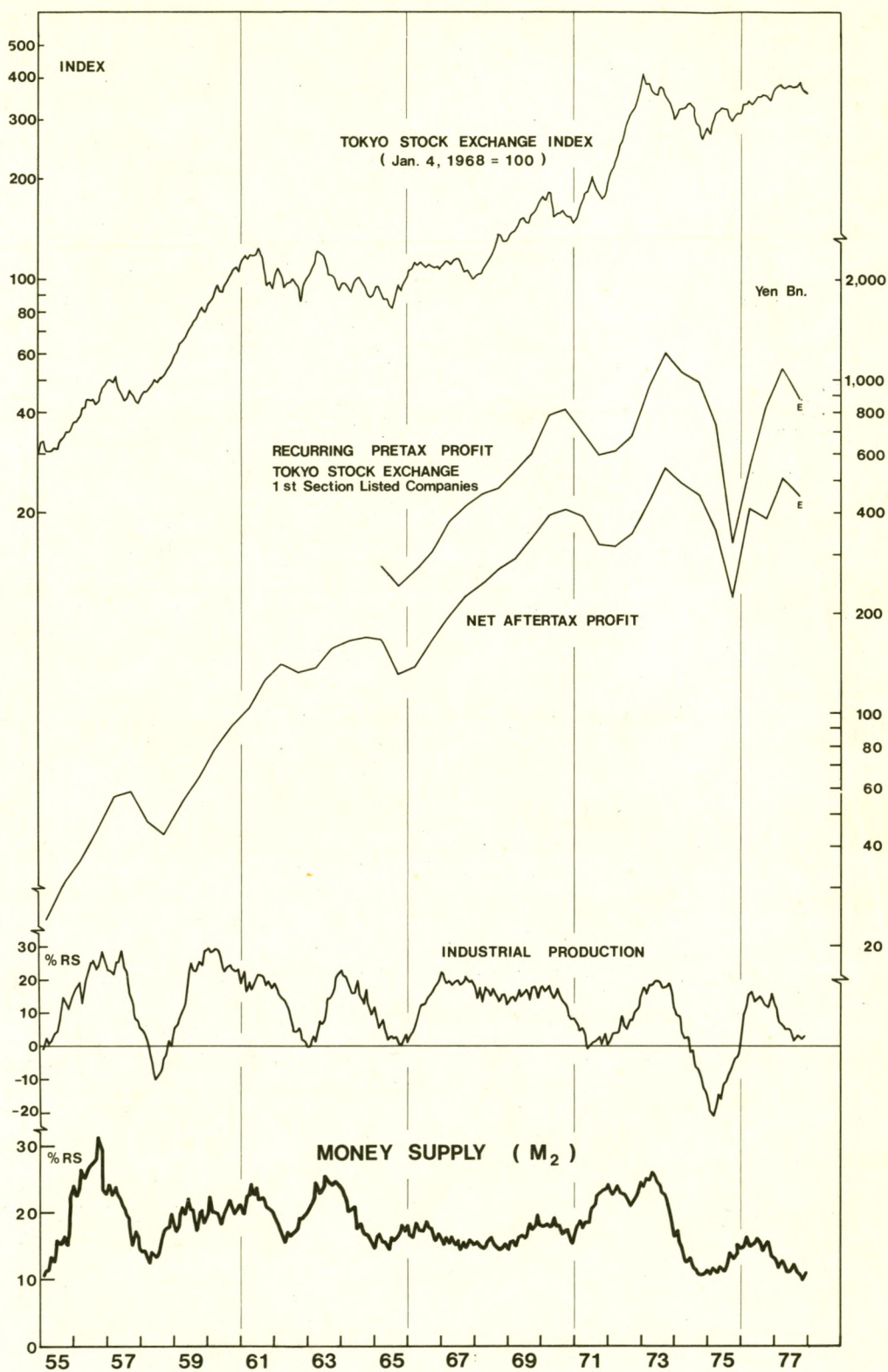
JAPAN
CHART 6 : THE STOCK MARKET AND 4 LIQUIDITY INDICATORS



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JAPAN

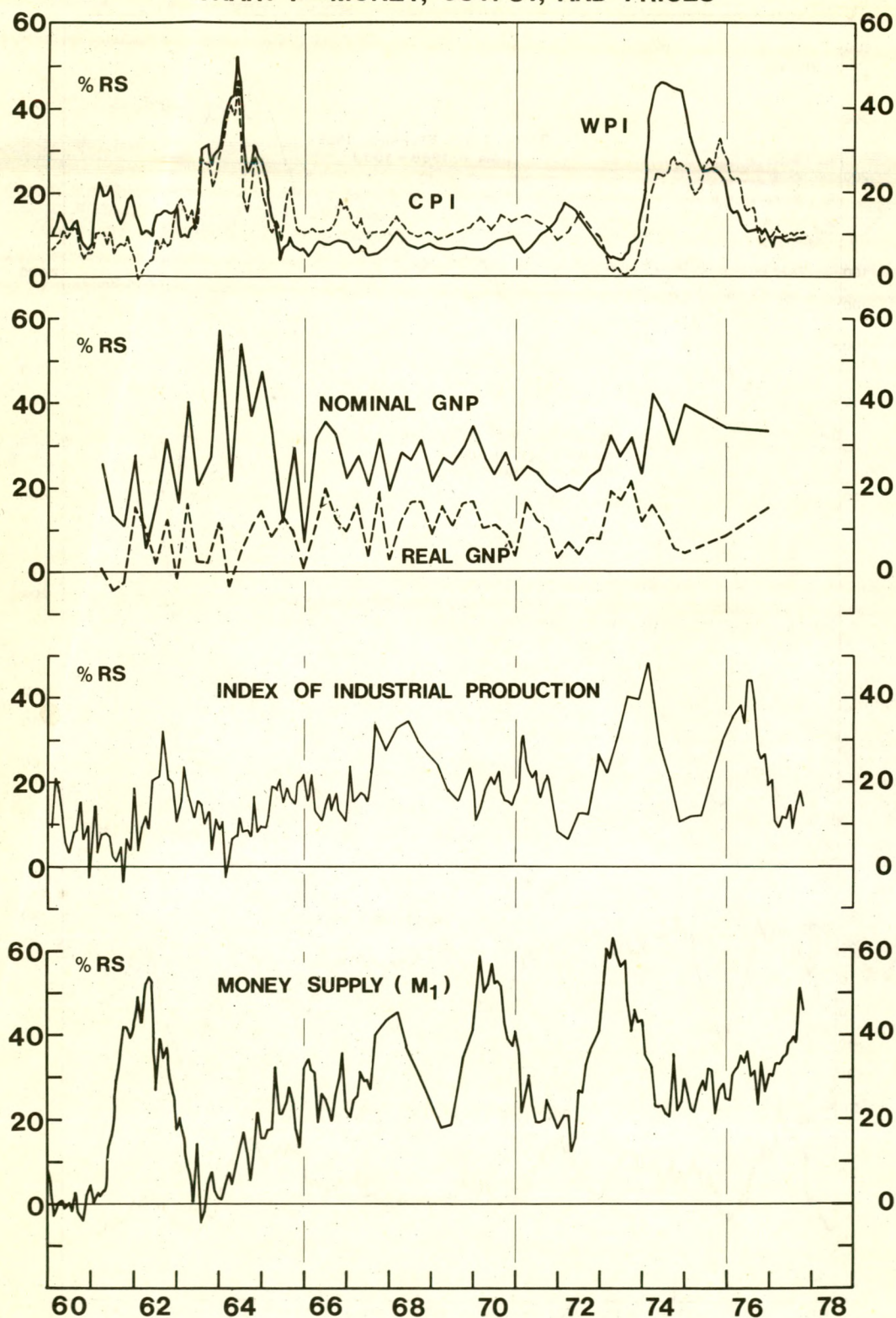
CHART 7 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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SOUTH KOREA

CHART 1 : MONEY, OUTPUT, AND PRICES



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KOREA

BUSINESS CYCLES AND THE EXCHANGE RATE, 1950-1977

Since the early 1960s the Korean economy has experienced an unusually high real growth rate. During the years 1962-76 which were also the years of the Republic's first three Economic Development Plans the average annual growth of real GNP was 9.8 percent per annum. In 1977 real GNP grew by 10.3 percent, and the authorities expect a similar performance for 1978. With the rise in aggregate GNP, the population has also grown at an annual average of 2.2 percent so that real per capita income has grown more slowly at about 7.6 percent. However, income growth has by no means been stable over the period, and certain areas of the economy have exhibited marked cyclical fluctuations. The purpose of this article is to explore the relationship between monetary growth, the fluctuations in real and nominal income, and the impact of these cycles on the foreign exchange rate.

Taking the years 1960 to 1977, growth of the narrowly defined money supply has averaged fractionally over 30% per annum, while broader definitions of money supply have generally grown somewhat more rapidly. Since we have been unable to obtain a consistent data series for M_2 except on an annual basis, the measure used here is M_1 . As it happens, in the past three years the growth rates for M_1 , M_2 and M_3 have all been remarkably similar so that for predictive purposes it probably does not matter very much which particular definition is adopted, at least for the time being. Chart 1 sets out the patterns of fluctuation for money, industrial production, nominal and real GNP, and consumer and wholesale prices in the period since 1960. Measuring the changes in the rate of growth of the money supply on a trough-to-trough basis, there have been four clear cyclical episodes since 1960, and it would appear that a fifth episode appears to be in the process of formation.

It is clear from the chart that in the first four cycles variations in the level of industrial activity follow a similar pattern to that marked out by monetary growth. The first two cycles of money growth (1960-63 and 1963-69) were followed with a fairly considerable lag by changes in the rate of industrial production. The transmission of the more rapid monetary growth into higher prices took somewhat longer so that the peak in inflation was not reached until May 1964 just over two years after the peak in money growth in April 1962. The peak inflation rates were only slightly less in percentage terms than the peak money growth rates. The second cycle was much more extended, and, starting more moderately, industrial expansion was sustained for much longer. In this cycle (1963-69) more rapid monetary growth appears to have been more nearly absorbed by an accelerating trend in industrial production, a sizeable decline in income velocity from 1965 onwards (Chart 2), and the result was a lower and steadier inflation rate in the 5-18 percent range.

The third cycle in money growth, 1969-72, is interesting because it was not associated with such a large upswing in industrial production, but there was a pronounced upturn in the rate

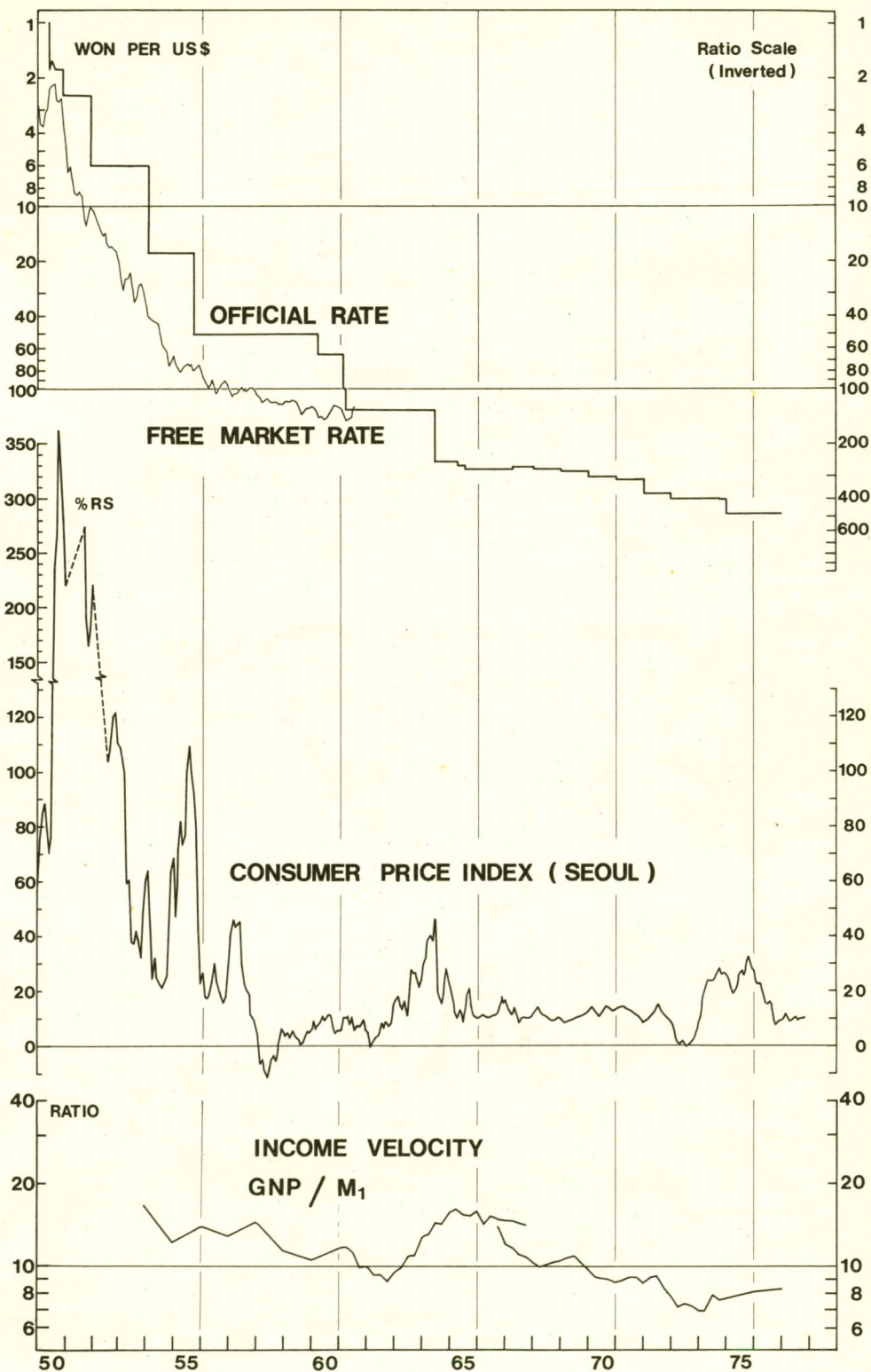
of wholesale price inflation in 1971-72. The fourth cycle of money growth (1972-74) and its consequences for industrial production and prices resemble very closely the pattern observed in numerous other industrial economies at this time, but in contrast to Japan, for example, Korea's monetary growth has remained at a relatively high rate since the trough of the recession in 1974-75. Similar to the period after 1965, consumer and wholesale price inflation rates have remained around 10 percent, and after a very sharp initial surge - starting in late 1975 - industrial production has returned to more sustainable 10-20 percent range. The fifth cycle in money growth appears to have been initiated from the external payments side. In 1977 Korea's foreign exchange reserves soared to US\$4322 million, up 46 percent from US\$2960 a year earlier. With the Won/US\$ exchange rate pegged at Won484 the Bank of Korea has been selling Won to hold the rate at parity. Since these Won have added to the reserves of the banking system and there has been no corresponding reduction in other assets of the central bank, monetary growth has been more rapid than it would have been under an alternative mechanism.

In the past few years the Bank of Korea has used changes in Reserve Requirements as a primary instrument of monetary control, but no such change has been made since April 16, 1976. Going back to the 1950's and early 1960's before the Bank of Korea effectively closed off the free market in foreign exchange, the Bank would from time to time auction specific amounts of US dollars - e.g. US\$10 million at a time - permitting the buyers also to purchase certificates of entitlement to import particular commodities, machinery, or other foreign goods. At a time when the inflation rate was far higher the authorities were thus able to adjust the official rate towards the market rate, but at the same time control imports. Today the inflation rate is much lower and the authorities have the opposite problem because there is upward pressure on the exchange rate.

FORECAST: A problem for the future is that if neither the exchange rate nor the monetary growth rates are altered, there could well be some acceleration in the rate of inflation in conformity with past business cycle patterns which could ultimately affect Korea's competitiveness vis-a-vis other South East Asian exporting nations. For the time being, and given a continuing large inflow of income from overseas remittances, the balance of payments could remain in surplus, but the inexorable upward pressure on domestic prices which this would generate must be considered a major policy issue within the next couple of years. In contrast to Japan, Korea has moved from a floating rate to a fixed rate with occasional readjustments. For both countries there have been problems associated with the new policy and it will be interesting over the years to observe the solutions reached in each case.

SOUTH KOREA

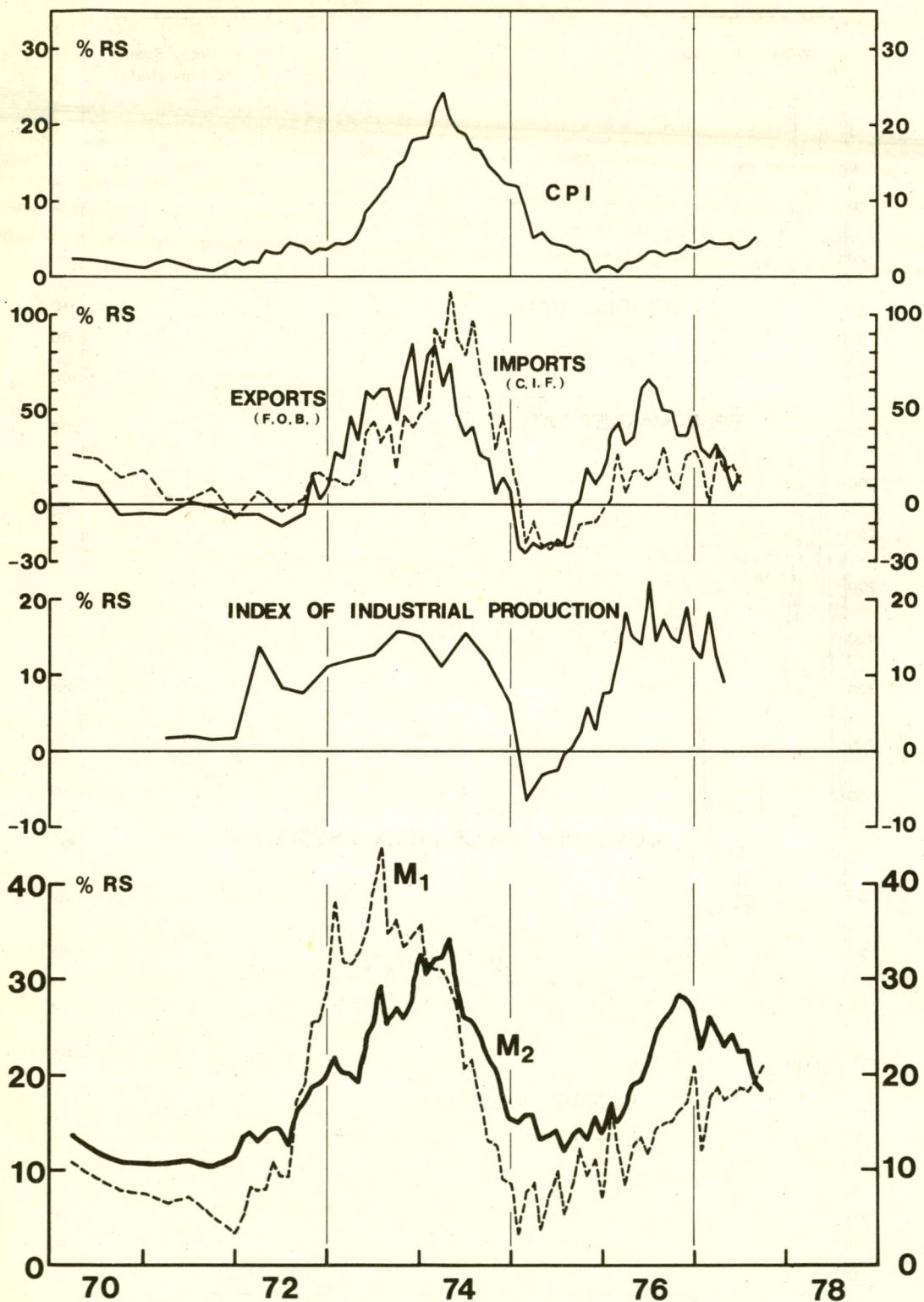
CHART 2 : VELOCITY, PRICES, AND, EXCHANGE RATES



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MALAYSIA

CHART 1 : MONEY, OUTPUT, EXTERNAL TRADE, AND PRICES



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MALAYSIA

THE DOMESTIC IMPACT OF THE EXPORT CYCLE UNDER A FIXED EXCHANGE RATE.

The economy of Malaysia in the 1970s has been dominated by wide fluctuations in the prices of her exports. Faced with a long run decline in the price of rubber - her major export - and deteriorating terms of trade throughout the 1960s Malaysia desperately needed to diversify the range of her export goods. Then suddenly the tables turned, the terms of trade shifted in her favour in 1972 and in recent years she has been in the enviable position of benefitting in two ways from the oil price increases, for the oil price rise caused both a substitution demand for natural rubber and an increase in the value of Malaysia's own oil exports.

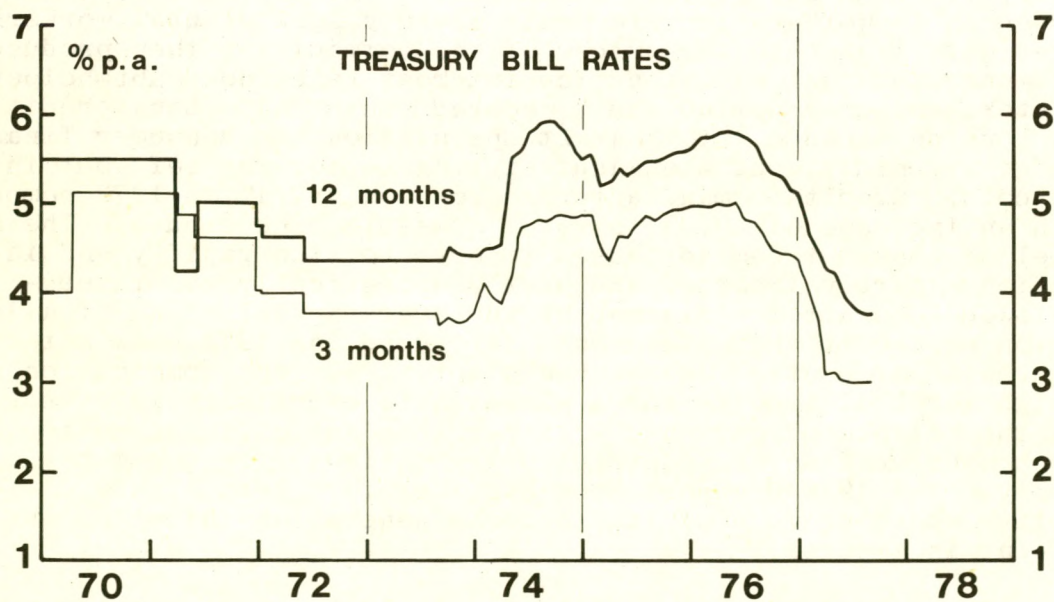
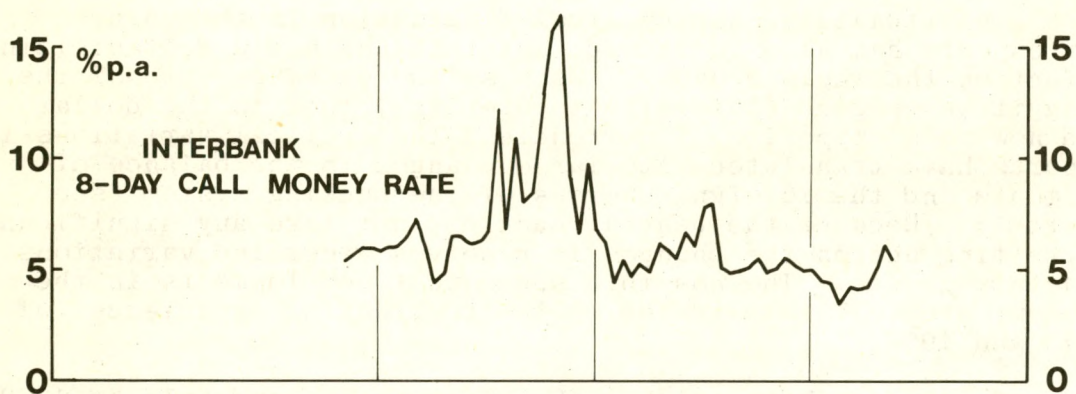
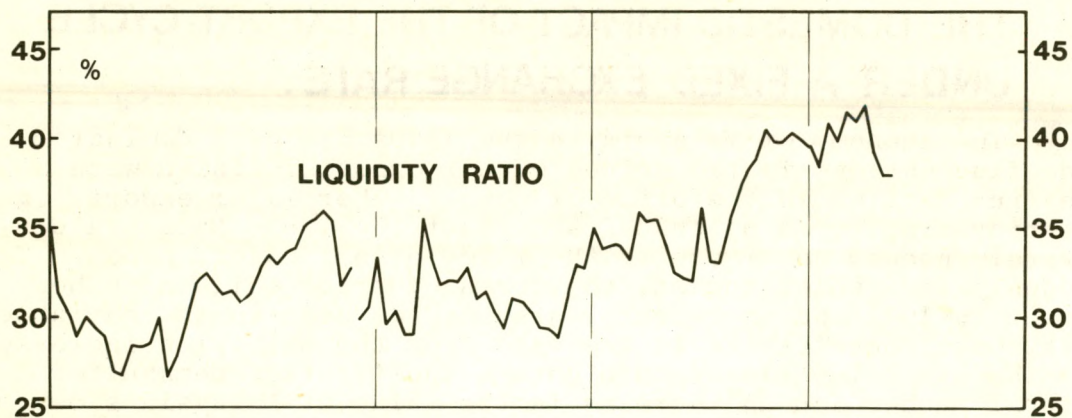
Unfortunately, the cyclical fluctuation in the volume of her exports has also increased, and this has had a destabilizing effect on the whole economy. Because the exchange rate of the Ringgit was pegged (initially to Sterling, then to the dollar, and now to a composite of currencies) the cyclical variations in exports have translated into large changes in the balance of payments and the foreign reserves of the banking system (see Chart 3). Because the central bank did not take any significant offsetting action the changes in reserves generated variations in monetary growth. The possible subsequent developments in the economy are well illustrated by the contrasting experiences of 1973 and 1976.

The export boom which took off in the second half of 1972 came at a time when the central bank was using low interest rates to try to stimulate private investment. The export earnings were passed on to workers in agreements whereby agricultural workers' wages were linked to the prices of the commodities they produced. The increased real wages and low interest rates no doubt helped to stoke consumer demand and M_1 soared (Chart 1). Bank credit for housing finance, stockmarket speculation and consumer finance all grew rapidly, but the manufacturing sector was left out in the cold. Credit to manufacturers rose only 7.1% in 1972 compared with an increase of 23.3% in total domestic bank credit. The high level of consumer demand caused imports to rise rapidly and inflation - partly imported and partly domestically generated - followed soon after. Alarmed by the over-expansion and misallocation of credit the government introduced the 1973 Bank Act to tighten their control on the banks but it was the combination of a high level of imports and a slowdown in exports in 1974 weakening the balance of payments - rather than any official action - which exerted a severe contractionary influence on the money supply. The 1972-3 export boom had therefore been highly disruptive spending much of its force in generating inflation and drawing in imports.

When exports again accelerated in 1976 interest rates were still high, consumer confidence was low, and M_2 alone surged ahead. The increasing emphasis placed by the government on participation by Bumiputras in the control and ownership of

MALAYSIA

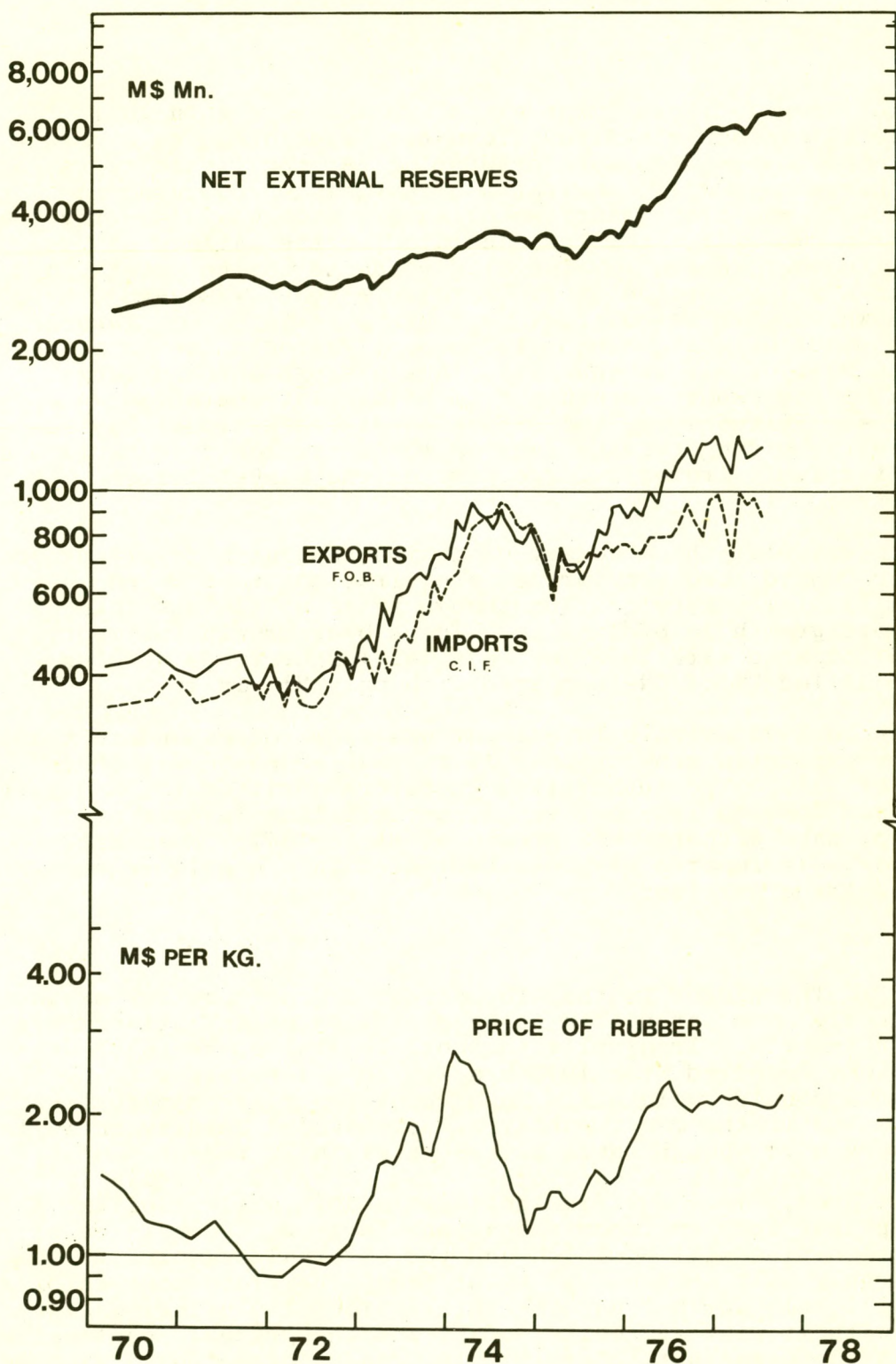
CHART 2 : BANK LIQUIDITY AND INTEREST RATES



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MALAYSIA

CHART 3 : TRADE AND RUBBER PRICE



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companies hampered investment plans and the uncertain world economic climate made business investors cautious. As a result suitable borrowers were not forthcoming and the liquidity ratio of the banks rose while the ratio of savings to GNP also increased. It was clear that the private sector was resisting the very strong monetary stimulus generated by the balance of payments. Another reason for the slow response to the growth in M_2 was that a major portion of the foreign revenue was earned by oil exports which were in contrast negligible in 1973. Through taxation and the state-owned oil company Petronas the government controls 83½% of oil revenues and thus has prevented a large portion of the export earnings from being distributed as wage increases. Furthermore, the expansion of the National Savings Bank and the stronger guidelines on the direction of bank lending have effectively frozen a large part of the banks' 'excess liquidity'.

Inevitably, the monetary expansion has had some effect on consumer demand, property prices are firm, consumer price inflation is slowly accelerating though it is still less than 6% and import growth is picking up. The slower growth in imports in 1976 compared with 1973 led to a far larger trade surplus which equalled 7% of GNP compared with only 2¼% in 1973.

As in 1972 private investment was slow to respond to the monetary expansion growing only 4% in 1976 compared with GNP growth of 11½%. The authorities therefore modified the Bumiputras policy and lowered interest rates, nevertheless investment only just kept pace with the GNP growth of 8% in 1977. Meanwhile the slow growth in imports has been reflected in a continued substantial trade surplus.

FORECAST: The danger is that the effect of the monetary expansion may suddenly come through in an acceleration of inflation and a surge in imports. Ironically the more restrained response of the economy compared with 1973 has led to a far larger trade surplus and a considerable build up of bank reserves exacerbating the stimulus to the money supply. The banks' liquidity ratio is still very high though there have been signs in recent months that their liquidity is declining. The expected slowdown in economic growth in industrial nations in 1978 will stabilize export prices and, as imports continue to grow, the balance of payments surplus will diminish and the external stimulus to the money supply will weaken. It is unlikely therefore that interest rates will fall further and the interaction of slowing monetary growth with growing aggregate demand and the gradual acceleration of inflation mean that interest rates can be expected to rise in 1978.

EPISODES FROM ASIAN MONETARY HISTORY

THE CHINESE HYPERINFLATION : Part 3

Price Stabilisation after the 1949 Revolution.

The accession of the communists to power in October 1949 did not provoke mass hysteria amongst China's business and financial community. Indeed, many were positively glad to see the downfall of the Kuomintang. The prevailing attitude was that nothing could be worse than the previous regime's incompetence and corruption. Moreover, it was not a question of a fully planned economy being imposed upon a utopia of entrepreneurial activity. Even before the communist victory the Hong Kong based Far Eastern Economic Review had pointed out as far back as February, 1948: "The Communists know, and they exploit this to the full, that one of the chief worries of the ordinary Chinese businessman today is the jungle growth of government monopolies and bureaucrat-controlled enterprises, often run for the personal gain of a few favoured politicians and generals."

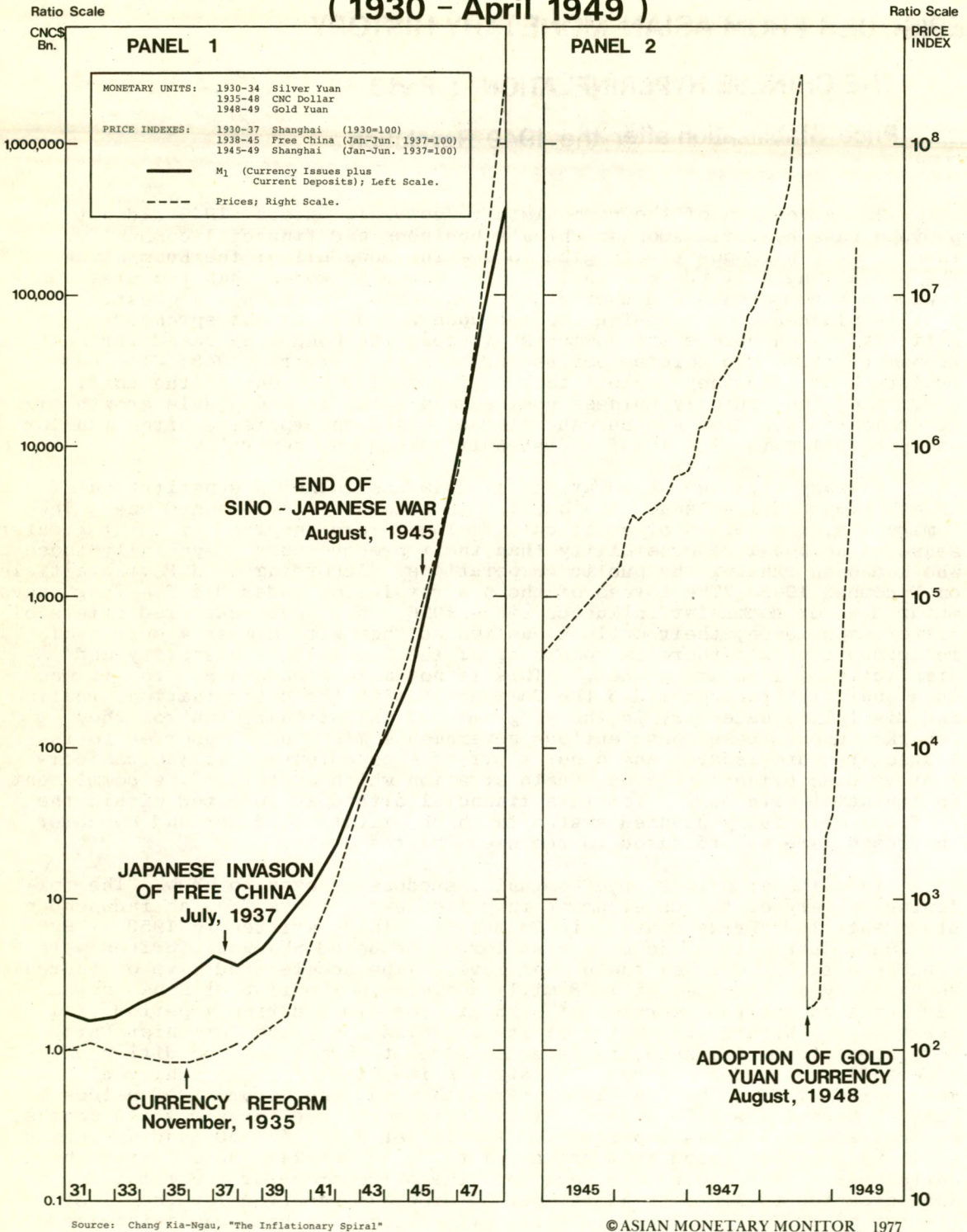
In many ways the "Liberation" of 1949 was rather a substitution of an efficient fully-planned economy for an incompetently planned one. The Communists, regardless of political ideology, were inspired by a far greater sense of national responsibility than their predecessors, especially those who had been running the public corporations. According to a Review article of December 1949: "The forces of the new revolution under Mao Tse-Tung" have matured under communist influence since 1926; they have weathered trials of bitter experience; their outlook has imbued them with almost a spirit of religious revival; there is something of the Cromwellian austerity and simplicity of life among them." This is not mere propaganda. For it was such qualities that provided the Communists with the determination, realism and discipline necessary in the programme of inflationary control they embarked upon. Less conscientious governments might have resorted to inflationary note issuing and other short-term expedients. It was the collective discipline of the new administration which sustained the commitment to financial orthodoxy. Yet this financial orthodoxy operated within the confines of a fully planned system in which private producer and consumer interests were subordinated to the needs of the State.

In terms of prices, the Communist success is easy to show. The following summary of the development in price levels comes from an independent study entitled "Price Control in Communist China", written in 1953. "By May 1949, just before the Communist forces occupied Shanghai, prices were roughly 8 trillion times the prewar level. The accelerated rate of increase is shown by an increase of 1.28 million times in a period of nine months vis-a-vis an earlier increase of 6.25 million times during a period of 11 years Within six months of its establishment, the Communist Party Government (CPG) was able, in large measure, to bring this condition of hyperinflation under control. Relative price stability was achieved in most parts of China by June 1950. From then on, the movement of prices in general became steadily upward. This trend continued for almost 15 months; an increase of 24% was reported for the latter half of 1950, and an increase of 15.9% for the period from January 1 to September 24, 1951. After the latter date, prices began to decline: the price drop for the remainder of 1951 amounted to 1.6%; an additional 5% drop was reported for the first quarter of 1952 Thus, relative price stability has been maintained for at least two years."

RAISING OUTPUT AND CONTROLLING DISTRIBUTION

The control of inflation was at the top of the new government's list of priorities. This confirms the view that mismanagement of the economy and the resulting hyperinflation were among the major reasons for the Kuomintang's downfall. The Communists did not want a repeat performance. The

MONEY SUPPLY AND PRICES IN CHINA (1930 - April 1949)



essence of their anti-inflationary strategy lay in attacking the causes at the economic level, rather than by imposing a host of politically-motivated, superficial measures to suppress the symptoms. Emphasis was placed on correcting two main areas of policy - the deficiency of supply, and the uncontrolled monetary expansion.

From the very beginning, the CPG concentrated on increasing production of essential commodities such as grain and cotton. Technical improvements, like irrigation, were made, self-sufficiency encouraged and mutual aid teams developed. One interesting feature was the use of competitive campaigns amongst workers with the aim of stimulating production. Ideology did not inhibit the new government from acknowledging the basic human motivation of self-help. To back up the production drive, the state trading company was developed. It was this institution which did most to reduce the deficiencies in supply. Through the control of both production, distribution and the allocation of food coupons the state companies and the local soviets together eradicated the profits of speculators, who had benefitted from fluctuating regional price levels and commodity hoarding. Rationing, intervention, and ideology took over from market prices.

By September 1950 some 4,200 branches of the state trade companies were already established. Their growing number directly threatened the livelihood of surviving entrepreneurs. They secured an increasingly large share of the market of a particular commodity, while their network of branches allowed them to keep that share mobile. Theoretically the authorities could thus prevent any sudden regional shortage in a commodity resulting in panic buying and accelerating prices. Control was further extended by the trading companies' practice of setting up state retail stores. Thus, in the case of goods which were purchased from state manufacturing enterprises, or obtained from the levy of tax in kind, the state controlled the distribution from the production stage right through to the final retail sale.

A specific example of the policy in operation occurred in February, 1950. In the hope of profiting from a shortage in supply, Peking merchants hoarded grain during the Chinese New Year celebration. The challenge was met by the Peking Municipal Retail Co. Its total supplies were mobilised, opening hours were extended, and supplies dumped on the market until consumer demand was satisfied. On New Year's Eve the total sales of the state retail company amounted to over 360 million tons. This was sufficient to satisfy the holiday demand, the outbreak of widespread panic buying sprees was prevented, and the profits of grain hoarders vanished overnight. The obvious analogy is with a bank run, the key factor being the intangible one of public confidence.

The success of the state trading companies is shown by a change in the nature of public demand. As the supply of essential commodities was secured on a more regular basis, demand appeared to shift away from "perfect inelasticity". People were no longer prepared to pay anything to obtain goods, and private merchants were therefore obliged to bring their prices down to the level of the state trading companies. Through a policy of outright competition, backed by the resources of the state, the trading companies secured "price leadership" in the most vital commodity markets. An interesting example of the new government's financial orthodoxy within a controlled system was the state trading companies' method of pricing their goods. Despite enjoying a growing monopoly of distribution, the normal cost/profit considerations of a private firm were employed in fixing prices. The new authorities were not prepared to subsidise losses. For it was no use reducing price instability on the one hand, while at the same time stimulating inflationary pressures by sheltering the public from the real costs of production.

Under the Kuomintang, hoarders, speculators, and other free market spirits flourished. The KMT neither owned nor controlled the means of production, nor did it possess the administrative capacity to enforce the flood of decrees issued by its officers. Since monetary growth was almost

totally without restraint, prices sky-rocketed. However, because the people were in large measure at liberty to protect their own interests, the laws and the authority which prevented people from doing so fell into disrepute. Under the Communists, hoarders, speculators and any surviving free market spirits were defeated by a combination of control over production and distribution and the inescapable power of authority. Gradually as monetary discipline was restored prices stabilised, and since the controls remained in place and the CPG could enforce the law, the counterpart was a parallel diminution of the market economy. The result was stable prices, respect for authority, but a loss of personal freedom.

FISCAL AND MONETARY REFORM

A major underlying cause of the hyperinflation had been the Nationalist government's inability to balance the budget. Expenditure had risen to levels far beyond the resources of public revenue, while bond issues had failed to attract subscribers. The new government, by contrast, was acutely aware of the urgent need to balance revenue and expenditure. Yet they faced a real dilemma. In order to curb inflationary pressures, money had to be invested to build up the nation's productivity. In the context of the planned economy, this meant investment in state enterprises, and therefore greater expenditures.

Despite this problem, fiscal policy was rapidly brought under control. Whereas in 1947 and 1949 the net budget deficit of the Kuomintang had approached 80% and 66% of expenditures, respectively, the first full year of the new administration (1950) saw the budget deficit slashed to 16.7% of expenditure. This result was achieved despite the 23.9% of expenditure directed towards investment in state enterprises. The success of the overall policy is clear from the 21.7% of total revenue that was collected over and above the budgetary estimate. This figure was to keep rising in subsequent years.

The success of the fiscal reform can be attributed to several factors.

- 1) The budget was calculated on a commodity unit, the "fen". This was to prevent the erosion, through inflation, of a purely monetary unit. The essential commodities used were rice, wheat, flour, cotton and coal.
- 11) To offset the expenditure on investment in state enterprises and the continued military costs, severe economies were made in the administration. Public officials' wages were drastically cut, with the result that civil servants lived at a virtual subsistence level. The austerity of the new government, in sharp contrast to its predecessor, is clear from Chen Yin's announcement at the CPG's first anniversary: "If the People's Government and the People's Liberation Army are to serve the people unconditionally, the way to reduce expenditure within a definite period of time is to limit the pay of military, civil and educational personnel." The contrast with the Kuomintang officialdom is glaringly apparent. Other cost-cutting measures were also taken. Self-sufficiency was encouraged in government departments, while the government assumed centralised control of the distribution of expenditure. Allocations were carefully scrutinised and unnecessary expenses dropped.
- 111) Borrowing from the public was re-introduced with the issue of "People's Victory Bonds" in 1950. The total amount of the loan was 200 million fen with a 5-year maturity. To make the issue more attractive, payment of the 5.1% coupon was freed from income tax. Also, 30% of the subscription could be paid in gold, foreign currency and foreign exchange. However, a secondary market in the Bond was prohibited due to the government's dislike of speculative trading. In total, 70.4% of the issue was subscribed, a commendable achievement in view of the high residual inflation at the time, and the public's previous scepticism towards the

Nationalists' bond issues.

However, subscription was not always purely voluntary. Since the issue was meant to soak up the spare cash of the business and merchant classes, an aggressive selling campaign was directed at these particular sections of the community. Douglas Paauw describes the process: "The government bond issues were distributed primarily among private business and commercial interests. Each administrative area was assigned a definite subscription quota, and these quotas were, in turn, allocated among private producers who had no option of refusing subscription to these securities. The net result of these loans was the transfer of substantial amounts of liquid business assets to the government."

- IV) The revenue from state enterprises grew, in line with Mao Tse-tung's prescription of 1942: "To increase our revenue by developing the economy is a basic principle of our financial policy ... the conservative viewpoint of neglecting to explore the sources of revenue and attempting to solve financial difficulties by contracting indispensable government expenditure cannot solve any problem."
- V) The tax collection process was completely reorganised, and efforts were made to reduce evasion. Incentive schemes were drawn up to encourage greater efficiency on the part of the local tax authorities. A directive of March 1950 provided the local administrative district with 70 or 80% of tax receipts collected over and above the fixed quota.

Turning to monetary reform, the first tasks facing the CPG were the stoppage of subsidiary note issues in the Liberated Areas, the unification of different currency areas and provincial banking systems, and the calling in of old currencies. A new unit, the "People's Currency", was introduced about a year before the PRC came into being with the establishment of the People's Bank of China on December 1, 1948. According to Tadao Miyashita, "We have no detailed information as to the system governing the issue of People's Currency, but on this point the Head of the People's Bank of China, Nan Han-chen, declared on the occasion of the opening of the Bank that it was not based on precious metals or foreign exchange, but was backed by the things which the people required - grains, cotton cloth, raw cotton, and other such means of livelihood and fruits of production (Hua Shang Pao, Dec. 6, 1948)." (The Currency and Financial System of Mainland China). In effect the PRC capitalised on the prevailing mistrust of paper standards to revert to a commodity standard, though this time the commodity adopted was neither silver nor copper, nor any other precious metal, but a basket of daily necessities. In the early days the integrity of the commodity standard was guaranteed by a promise that fixed deposits were redeemable either in bank notes or in commodity units. During the hyperinflation, money - CNC\$, Japanese puppet issues, or indeed communist issues - had survived as a medium of circulation but had been almost universally rejected as a store of value: the commodity standard was aimed at restoring the latter function.

The restoration of confidence in the currency was accompanied by changes in behaviour reflected in two significant ratios: a rise in the deposit-to-currency ratio, and a decline in the income velocity of circulation. Money consisted of two essential components: bank deposits and currency held by the public. During the hyperinflation, a substantial shift out of bank deposits into currency had occurred, since with the massive devaluation of money there had been little incentive to hold funds on deposit. People had spent what they had, as quickly as they could, in the face of certain price increases. Only by restoring the ratio of deposits to currency would the People's Bank be able to mobilise the People's money balances to grant loans to the State enterprises. Consequently, a crucial aspect of the Communists' monetary policy was the encouragement of saving through the holding of bank deposits. Therefore, a vital prerequisite for

When Good Money

Drove Out

Bad ...

On October 18, 1948, the A.P. News correspondent in Shanghai reported: "Taking advantage of their victories at Chinan, Chinchou and elsewhere, the Chinese Communists are opening an offensive against the Kuomintang government on the economic front. Whenever the Chinese Communist armies capture a town they confiscate all the Gold Yuan Notes on the market. These are then sent to the great cities, to Shanghai, Tientsin, Tsingtao or Peip'ing. Communist organs in these cities use these notes in buying up rice, cotton cloth, woollen goods, drugs, radios and other articles of daily use. They will pay 3-4 times the normal market prices in buying up these goods. As a result, the prices in the great cities have risen all the more, and material resources in short supply have become even more scarce." (Quoted in Miyashita, The Currency and Financial System of Mainland China.)



In the final stages of the war against the KMT the communists turned Gresham's Law on its head. As popularly expressed, the Law states that 'bad' money drives out 'good' - provided the exchange rate between the two is pegged. To undermine the Gold Yuan (GY) issued from August 1948 onwards, rates of exchange against the various communist currencies were fixed at rates unfavourable to the GY in the light of prevailing prices, and this drove out the GY from liberated areas. Finally, when in a last desperate throw the KMT issued Silver Yuan Notes from Canton the communists declared the notes worthless and that holders would receive no People's Currency in exchange. The 'good' money had driven out the 'bad'.

curbing inflation was to alter the public's expectations about the future value of money balances. Two specific measures are noteworthy. The assurance of "guaranteed value of principal", through the withdrawal on maturity of fixed deposits in either bank notes or commodity units reduced the public's fear of the long-term erosion of monetary value through inflation. The introduction of "fixed or current deposits as desired" allowed the deposit-holder to benefit from both unrestricted withdrawal and high interest rates. By June 1950 it was officially estimated that there were already over one million accounts under these two systems. Confidence in the currency is reflected in the growth of aggregate real money balances from 1950 onwards, as shown in the table opposite.

REAL MONEY BALANCES IN CHINA, 1949-57

Year	Money Supply Yuan billion	Retail Price Index 1952=100	Wholesale Prices in Shanghai June 1949=100	Index of Real Money Balances	
				(A) 1952=100	(B)
1949	-	-	529	-	-
1950	2.60	-	2179	-	0.45
1951	4.68	-	2875	-	0.62
1952	7.63	100	2904	1.00	1.00
1953	9.42	103.2	2860	1.20	1.25
1954	10.18	105.5	2871	1.26	1.35
1955	12.13	106.3	2881	1.50	1.60
1956	18.98	106.3	2873	2.34	2.51
1957	15.12	108.6	2886	1.82	1.99

Notes: Money Supply was derived from Katherine Huang Hsiao, Table VIII-I
Retail Price Index, *ibid.*, Table IX-2; Wholesale Prices from
Miyashita Table III-2.

The Communists' monetary policy also concentrated on minimising the role of cash in the state sector. The People's Bank extended its control over the cash balances of all government departmental units. All inter-unit payments within the public sector were cleared through the Bank, while the use of cash for settling expenses was strictly limited to the payment of wages and purchases in the rural areas, and expenditure at the retail level in the cities. Each unit also had to draw up a currency receipt-and-disbursement plan. This was checked by both the People's Bank and the appropriate government administrative committee.

The rationale behind these measures was to accumulate as much surplus cash as possible in the People's Bank. Campaigns were launched to encourage private individuals to deposit their savings, while cash expenditures in the public sector were confined to the minimum. The process was well summarised by Katherine Huang Hsiao: "The People's Bank achieved the role of the centre of cash, credit and settlement, from which the supply of money originated, into which currency held in the state sector was deposited, and through which inter-state-unit payments were effected." ("Money and Monetary Policy in Communist China.") Thus the monetary policies pursued were not merely the consequence of a commitment to reduce inflation. They were also consistent with the development of a socialist economy, in which all the available resources were increasingly controlled by the State and used for the State.

The new Communist government was thus completely successful in its efforts to wipe out the hyperinflation. Many of the policies were far from novel, relying on sound financial orthodoxy. Fiscal reform was implemented and monetary expansion controlled. Yet it was at this point that the commitment to classical orthodoxy ended. For without wishing to digress into the area of political philosophy, the measures taken by the Communists to restore price stability were but one part of their overall programme of mobilising China's resources under the control of the State. For this to be achieved, it was necessary that the inflationary chaos be terminated. The direction of the CPG's programme is clear from the "Three Anti" and "Five-Anti" movements of 1951-2. Amongst the targets for attack were bureaucracy, corruption, waste, bribes, tax evasion, and the theft of state assets. Many of these evils were the continuing legacy of the Kuomintang inflation.

In purely administrative terms, the CPG's measures were exceedingly demanding. In the initial years policies were not always effectively enforced throughout the country, although the trend was towards greater efficiency rather than less. The ability of the Communists in this respect is clear from their success in redeeming the ten different Communist currencies that had circulated during the Civil War, as well as the Kuomintang's

note issue. Monetary unification, was completed by October, 1951, a vital prerequisite for control of the money supply and the success of the price stabilisation programme. The whole operation was carried out with remarkable orderliness - a notable feat of organisation in view of the amount redeemed and the potential for disorder.

The first years following the "Liberation" are therefore highlighted by the Communist success in stamping out inflation. Despite the subsequent outbreak of the Korean War in June 1950 and the Nationalists' coastal blockade directed from Taiwan, both of which aggravated inflationary pressures in the economy, prices remained stable.

* * * * *

There is a grim irony in the chain of events which started with the U.S. Silver Purchase Act of 1934, was followed up by the substitution (in late 1935) of what was effectively a paper standard for the silver standard, American indifference or at least neutrality towards Japan's incursion into China, the progressive disintegration of fiscal and monetary discipline in 'Free China', the growing disaffection of the Chinese people towards the Kuomintang, Chiang Kai-shek's precipitate downfall, and the Communists' ultimate victory: it was the legislators in Washington who unknowingly tipped the stone that shifted the rock that started the landslide. The financial indiscipline and spend-thrift policies of the Nationalists, contrasted with the financial conservatism and Cromwellian austerity of the Communists, is above all a blunt reminder that neither monetary chaos nor monetary stability are the property of any ideology.

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BOOK REVIEW

"Why China Has No Inflation." by Peng Kuang-hsi.

Foreign Languages Press. Peking.

The people of China, we are told in this refreshing booklet, are free from inflationary worries. "Many housewives don't even know what 'inflation' means". Indeed, a long list is given of examples of prices which either have not changed or have actually declined in the past ten years. Many prices have fallen dramatically: alarm clocks which cost 15.80 yuan in 1965 cost only 8.00 yuan in 1974, but aluminium lunch boxes show a less spectacular reduction in price. The monthly budget in 1965, 1970 and 1974 of the "rather typical" Chang family is also examined. The static composition of Mr. Chang's budget is impressive: not only has there been no inflation but also there has been almost no change in his expenditure.

The secret of this success? The state controls all prices: "When... the supply and demand for .. daily necessities get out of gear, the state never raises prices since that would be against the interests of the working people". Pertinent questions which the author does not answer are whether there is a black market in any commodity and whether there is persistent rationing. For rationing and black markets indicate that price stability is being maintained by restricting the purchasing freedom of the individual.

In contrast to the absence of inflation in the New China is the tragic history of hyperinflation under the Kuomintang. Strong words are used to describe the crimes perpetrated by speculators and hoarders and the "cold-blooded greedy usurers" who ran pawn-shops in the days of the Kuomintang. An amusing illustration of the effects of hyperinflation shows the two cows which 100 yuan would have bought in 1937 and the single sheet of toilet paper which it would have bought in 1947.

The last chapter in the book is the most important because there the monetary and fiscal policies of the communists are described. The problem of inflation is seen to be the outcome of imbalance between the money supply and the supply of goods. By planning both, the socialist state ensures that they are in balance and therefore there is no inflation. The analytical framework is thus essentially that of the quantity theory.

The government, it appears, follows conservative and prudent monetary and fiscal policies. The money supply is rigidly controlled by the People's Bank of China which is the sole source of loans, while the government maintains a balanced budget and "deficits are strictly prohibited". A certain proportion of the budget is set aside as a contingent fund and a stock of goods is maintained so that when unforeseen circumstances arise which cause the supply of money and the supply of goods to be 'unbalanced' - for instance when there is a bad harvest - the supply of goods can be augmented to bring them back into equilibrium. Interestingly there is no hint that monetary expansion could be used to stimulate output.

In stark contrast to the order which prevails under the socialist regime is the inflation which is "an incurable disease in capitalist society". Under capitalism "production is anarchic" and the "currency issue is not amenable to planning". Therefore there is inflation. Implicit in this 'argument' is the assumption that planning is necessary to ensure the balance between the supply of goods and the supply of money. The author assumes that the anarchy of capitalism i.e. the lack of central control makes the production of goods erratic and indeterminate, so any attempt at keeping the money supply in balance with actual output is doomed to failure. But it is not obvious that the aggregate level of

production of goods is unpredictable in a free market system, and control of the money supply is quite possible within certain limits. The fact that in the past such control was neglected or abused is not a necessary consequence of capitalism.

There is also some confusion in the attack on 'monopolists' who would rather destroy goods than sell them to workers at low prices. Monopolists set prices above the free market level, the destruction of produce occurs when prices are below the free market level. For instance, under the Nixon price controls in the US in 1971 poultry farmers found that they reduced their losses by destroying chicks rather than selling chickens at a controlled price which was below the cost of production. On the other hand the high prices charged by monopolists are claimed to cause inflation, but this is not so. Relatively high prices redistribute income, they do not cause inflation. Inflation is the phenomenon of increasing prices rather than high prices.

Nowhere does the author discuss the costs of maintaining stable prices. It appears that China does follow a conservative monetary policy and has not used Keynesian fiscal spending to stimulate production. This strategy probably contributed considerably to maintaining 'a balance' between production and the money supply, but the vigorous imposition of price controls and the suppression of free market activities make it impossible to assess whether their monetary and fiscal policies alone would have prevented inflation. Had price stability been achieved by the restrictions on freedom of choice and personal liberty? The author apparently believes the answer is 'yes', because "the socialist system is the safeguard".

China's exchange rate policy is put under vague scrutiny. Some purchasing power parity notion is employed, though export and import prices are controlled by the state and are fixed separately from domestic prices. The author went along to the Bank of China and posed a few tricky questions:

"Why have the West German mark and Swiss franc gone up in terms of RMB?"

"That is because of the appreciation in their value. The value of RMB has not changed."

"Is the upward adjustment harmful to China?"

"No such problem is involved. Adjustments, upward or downward, are made according to the principle of equality and mutual benefit."

The first answer is either tautological or wrong. If the domestic purchasing powers are being compared, the Swiss and Germany currencies have depreciated not appreciated because both these countries have experienced mild inflation. On the other hand if their exchange rates in terms of foreign currencies are being considered then the statement is fatuous. The second answer is just a bland assertion. Equality for whom? Equality of what?

Throughout the book too many questions are not answered and many more are not even asked. However, this publication provides a fascinating glimpse of the beliefs and ideology communist China wishes to present to the outside world.

The editors are happy to send copies of 'Why China Has No Inflation' free of charge to subscribers on request.

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

EURODOLLARS, ASIAN DOLLARS, AND THE US\$

In March 1977 the estimated net amount of all currencies held on deposit outside their national markets, which have come to be called Eurocurrency deposits, exceeded for the first time in postwar history the narrowly-defined domestic US money supply, or M_1 . By September 1977 net US dollar deposits, which typically account for about 80 percent of Eurocurrency deposits, exceeded the demand deposit component of M_1 by almost US\$33 billion. This is the cumulative result of almost two decades which have witnessed the growing use of currencies held outside their national markets. During the period 1969-77 net Eurodollar deposits grew at an average rate of 28% per annum. Included within the total of Eurocurrencies, Asian dollar deposits have experienced a parallel growth. Net Asian dollar deposits with banks in Singapore stood at US\$2.2 billion in December 1977, while those with banks in Hong Kong were estimated to be about half this size. If domestic US money supply totals were to continue to grow at the rates experienced in 1977 (7.4% for M_1 and 8.9% for M_2), net Eurodollar deposits would exceed the size of M_1 in the US by December 1978, and on the same basis they would overtake M_2 by the end of 1985.

These extrapolations are not predictions. Indeed it is extremely unlikely that U.S. domestic monetary growth will be permitted to grow at the accelerating rates experienced between early 1975 and late 1977, but the enormous magnitudes of the Eurodollar aggregates involved calls for critical study of the impact of these trends on the world economy. Against the background of the recent sharp depreciation of the US dollar on world currency markets and debate about the direction of policy under the new Chairman of the Federal Reserve Board Mr. G. William Miller, it is appropriate to ask to what extent the growth of this huge offshore supply of US dollars has contributed either to inflation in the U.S. or to the decline in the value of the world's key currency.

US\$ bn	Eurocurrency Deposits		US Money Supply		
	Net Eurocurrency Deposits	Net Eurodollar Deposits	Demand Deposits	M_1	M_2
March 1977	320	256	233.2	315.4	756.1
June 1977	340	269	238.0	321.9	772.8
Sept. 1977	350	277	244.0	330.4	792.9

Note : Net figures exclude interbank deposits.

Source: World Financial Markets, Morgan Guaranty Trust Co. of New York.

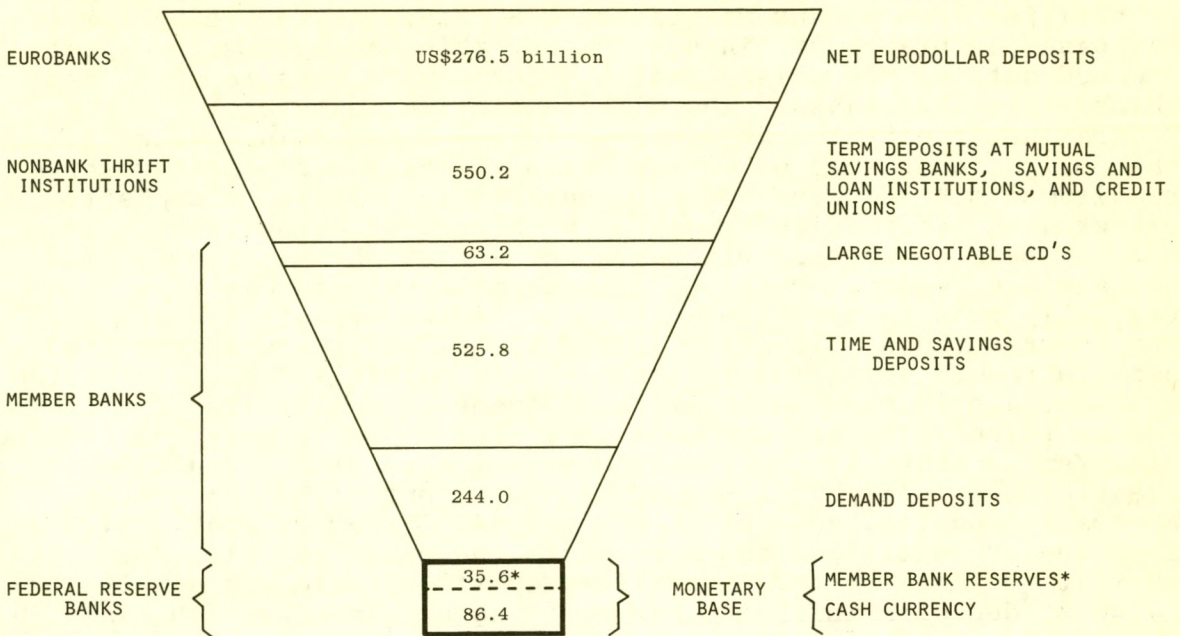
As a preliminary step it is useful to set out the mechanism of the Eurodollar market explaining how the supply of dollars outside the United States came to grow to this size - to examine in short the creation and use of (or the supply of and demand for) Eurodollars, and thence to assess the impact of this phenomenon on

US\$ DEPOSIT PYRAMID

As at end-September, 1977

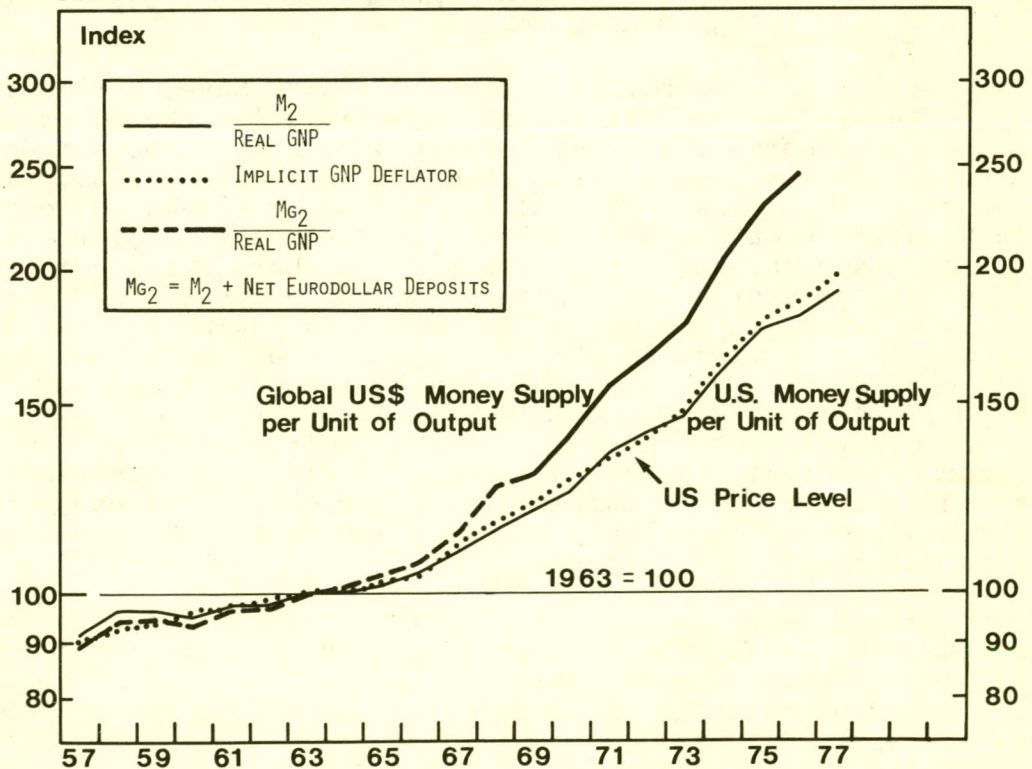
TYPES OF BANK

TYPES OF MONEY



* Not included in definitions of money supply.

EURODOLLARS AND THE U.S. MONEY SUPPLY CHART 1 : MONEY PER UNIT OF OUTPUT AND U.S. PRICES



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the internal and external purchasing power of the dollar.

Eurodollars are created by the transfer of US dollar deposit liabilities from a bank within the U.S. Federal Reserve System to any bank (or branch or finance company which accepts such deposits) located outside the United States. For convenience we shall call these banks Euro-Banks. The differentiating feature of the U.S. Federal Reserve System in contrast to the Eurobanking system is the obligation placed on Member Banks to observe explicit reserve requirements.* However, when US dollars are placed on deposit either with the foreign branch of a US bank or directly with a foreign bank neither of which are subject to the same obligation to maintain required reserves, the deposit-pyramid can theoretically grow to many times the size of the primary deposit transferred there. If a portion of the deposits are transferred back to the US this clearly inhibits the multiple deposit creation process, and in particular at one extreme the multiplier could reduce to unity if all proceeds from such deposits were redeposited with Member Banks in the US. The actual size of the deposit-creation multiplier will depend on the extent of leakages from Eurobank deposits back into deposits with US Member Banks. Viewed from the standpoint of the Euro-Banks the reserves which form the apex at the base of the Eurodollar deposit pyramid are simply the value of deposits which the Eurobanks hold as assets with banks in the US. At its current size, the reserve base for net Eurodollar deposits is still only a small fraction of domestic US deposits. Fears about the fact that there is no central bank 'backing' the Eurodollar system or that there is no 'lender of last resort' are therefore misplaced. The only real danger of a multiple contraction would be in the event of a multiple contraction initiated within the United States by the Federal Reserve itself.

Historically, a number of specific factors have contributed to the growth of the Eurodollar market, notably (1) the enforcement by the Federal Reserve System of Regulation Q (which imposed deposit-interest rate ceilings) and its periodic impact on the attractiveness deposits at US banks, and (2) the demand by non-US nationals to hold US dollars on deposit outside the jurisdiction of the US authorities. More broadly, the growth of the Eurocurrency markets should be seen a natural accompaniment to the expansion of trade and the liberalisation of capital movements following the partial removal of trade barriers in the 1960's, and the gradual move to currency convertibility. With the growth of world trade, individuals, corporations, quasi-government and government agencies and non-US central banks have diversified their asset portfolios either for prudential reasons, or simply in line with their more diversified activities. A multinational corporation or even the international businessman today requires and maintains deposits in several different currencies.

The aggregate demand of these entities and individuals for any one currency is in part a function of the value of the international transactions conducted, and in part a function of the relative costs of holding that particular currency. The reasons

* Member Banks participating in the Eurocurrency markets are subject to Regulation M which imposes reserve requirements on head office loans to overseas branches.

In his excellent book 'The Euro-Bank', Steven Davis sketches three distinct periods in international banking experience which provide a useful historical perspective on modern Eurocurrency business. Drawing first on Prof. Raymond de Roover's study of the Medici Bank, Davis describes their Eurobanking structure as follows:

"While no consolidated figures are available, it appears that non-stockholder deposits represented a multiple of up to ten times capital for individual branches. Fixed rate deposits could be acquired from money markets such as Antwerp on the basis of the Medici's prime name. Such deposits generally cost from 8-10 per cent per annum, while loans were made at rates of 12-14 per cent per annum. Overhead costs were minimal; in 1470 the entire network only employed fifty-seven individuals, or from four to ten per branch. On the asset side of the ledger, cash rarely exceeded 10 per cent of total assets, with loans or claims on other Medici branches representing the bulk of the remainder.

"Lending policy was established and generally enforced by guidelines laid down by the family and its general manager in Florence. Newly appointed branch managers signed contracts which, for example, required them to lend only to reputable merchants or manufacturers. Princes, noblemen and the clergy were generally considered bad risks except possibly on a cash collateralised basis. The new London manager in 1446 agreed not to accept bribes or lend to himself or his family ..."

* * * * *

"A unique phenomenon of the nineteenth century was the development of investment banking institutions such as the Rothschild bank, the Credit Mobilier and geographically specialised banks whose principal activity was the intermediation of long-term capital exports from England and France. Undeterred by depressingly regular defaults by private and public overseas borrowers, the British and French public through their bankers financed a world-wide programme of infrastructure and industry - railroads, canals, public utilities, mines and factories - through term debt and equity issues floated in London and Paris....

"The peak of the foreign-bond mania and the banking expansion which accompanied it was reached in the late 1870s. 'No country was so willing as England to expand credit beyond the limits of commercial prudence.' "

* * * * *

"The passage of the Federal Reserve Act in 1913, coupled with the outbreak of World War I which was to turn the United States from the world's largest debtor nation into a major creditor, precipitated a rapid expansion of foreign branches and subsidiaries of American banks. While a few consortium-owned subsidiary banks had been established under state laws in earlier years, the Federal Reserve Act permitted national banks to branch abroad and to accept drafts for the first time. The dollar acceptance thus came to play a major role at the expense of the sterling draft drawn on a country which had been hard hit by the war and whose post war balance of payments vulnerability was to severely restrict its former role as the world's banker."

* * * * *

In a secular perspective it would appear that the decline of sterling both as a reserve currency and as a trading currency in the post-World War II era were closely related to the weakness of the British economy and the UK's persistent balance of payments problems. These two problems are of course analogous to the real value of income and the relative value of the currency as motives for holding a currency. In the light of the more rapid secular growth rates of Japan and West Germany and the tighter control exercised over their domestic monetary policies it does not seem too far-fetched to foresee the Yen and the DM emerging over the longer term as co-equals with the U.S. dollar, at least so long as present American policies persist.

for holding foreign currencies may be hypothesised to be analogous to the reasons for holding domestic money balances. On the one hand the real value of domestic money balances is related to the real value of total domestic expenditures or real income; on the other the demand for foreign money balances would be related to the real value of international expenditures incurred or real income arising in several different countries.

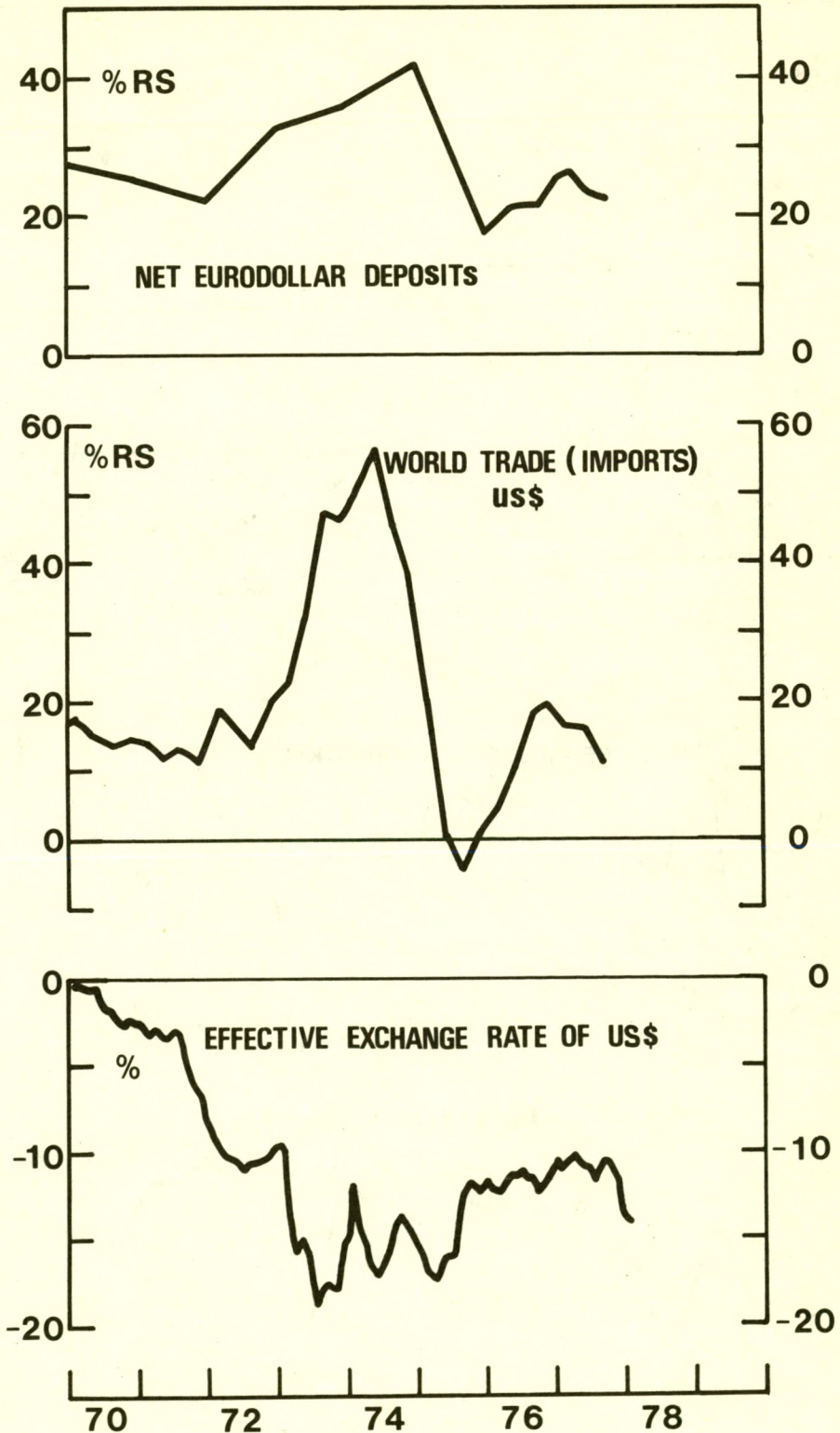
Similarly, whereas the demand for domestic money balances is influenced by the opportunity cost of holding money as measured by the inflation rate and the relative returns on other assets such as bonds and equities, the demand for various foreign currencies would depend on international comparisons of relative returns both in terms of the nominal yield on assets and expected exchange rate movements. Thus, the demand for foreign currencies is likely to be influenced by the value of international transactions and expected exchange rate movements.

As an empirical matter it is interesting to observe in Chart 2 that the pattern of Eurodollar growth exhibits a striking similarity with the growth of world trade. Secondly, it is also interesting to observe that historically external deposits or credits in a particular currency have tended to grow more slowly when that currency has been subject to balance of payments weakness and hence depreciation (see box on p.5). Given the rather short time-span for the available Eurocurrency data it is difficult to draw any firm conclusions about the relation between the value of the US dollar on world currency markets and the growth of net Eurodollar deposits. According to estimates by Morgan Guaranty Trust Co., US dollars have consistently accounted for around 80 percent of gross Eurocurrency deposits, suggesting that Eurodollars have grown paripassu with other Eurocurrencies irrespective of the value of the US dollar on foreign exchange markets. However, this may also reflect a variety of other factors such as residual restrictions on the use of non-resident Free Yen deposits by foreigners, similar restrictions inhibiting non-residents from holding Deutschmarks or Swiss francs, or the special role of the US dollar as an intervention currency under current international monetary arrangements. Neither of these two observations constitute proof that the two factors mentioned above are indeed critical factors determining the demand for Eurodollars, but they suggest that the theoretical analysis could be reinforced by further evidence of this kind.

An analogy can be drawn between Eurodollar banks and domestic US nonbank financial institutions. Individuals and corporations have the choice, in European countries, in Hong Kong, in Singapore or most other regulated banking systems of placing their deposits either with banks which observe the official reserve requirements, or with other institutions whose reserve requirements are either not mandatory or less stringent. In practice these secondary institutions hold some level of deposits or working balances with regulated banks and these deposits constitute the reserve base for the secondary deposit pyramid. Savings and Loans institutions in the United States, Building Societies in the UK, Finance Companies in Singapore, Deposit Taking Companies in Hong Kong etc. can all offer favourable terms to depositors. Either this is because they

U. S. A.

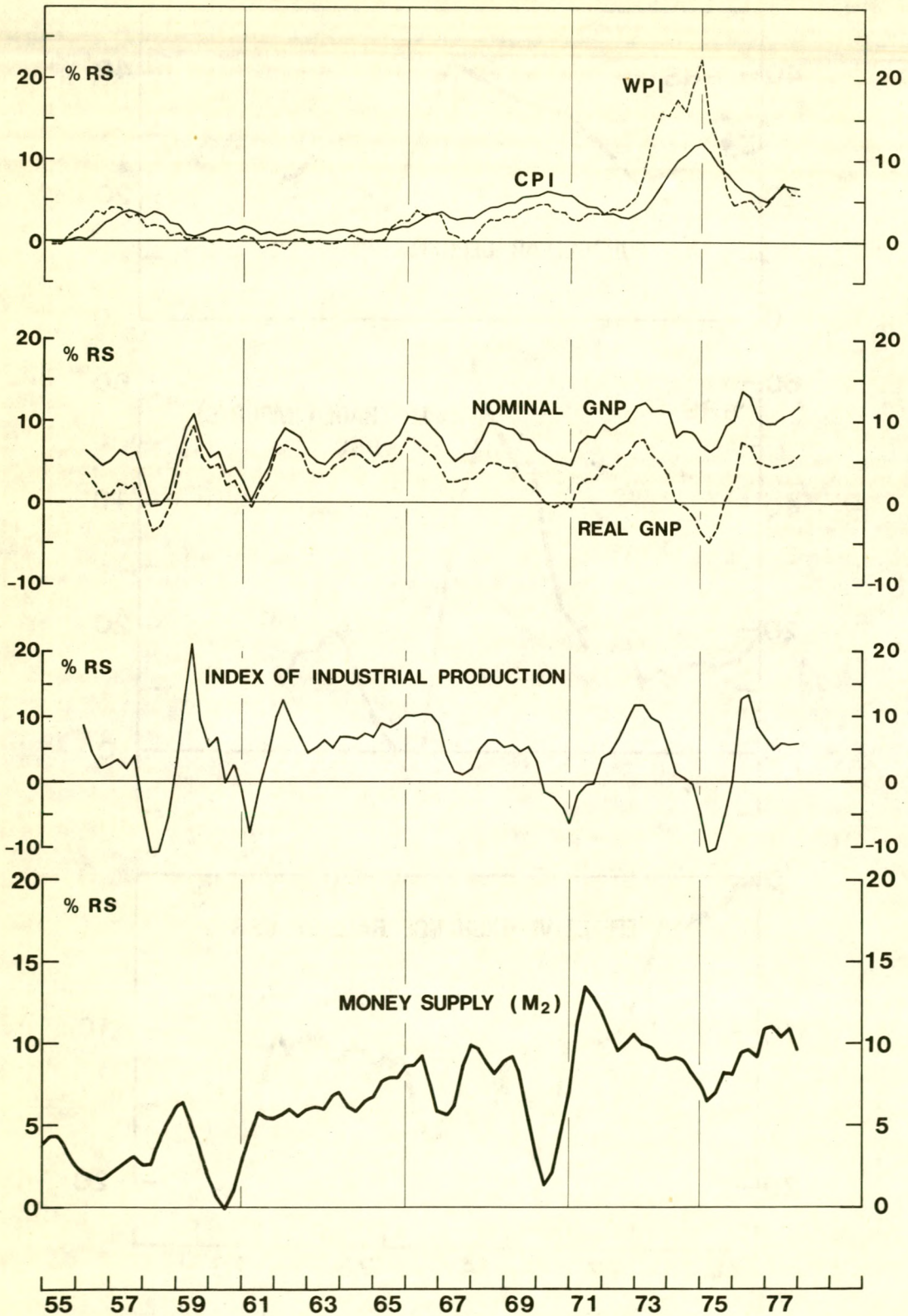
CHART 2 : EURODOLLARS, WORLD TRADE, AND THE US\$



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U. S. A.

CHART 3 : MONEY, OUTPUT, AND PRICES



are specialists, dealing only in large size deposits or fixed-term deposits and therefore have lower overhead costs per dollar deposited, or, being less stringently regulated, these banks are not so hampered in the disposition of their assets and can therefore offer attractive interest rates. Eurobanks are thus analogous in many respects to non-member bank financial institutions.

How has the growth of this extraterritorial banking system affected the inflation rate in the United States and the value of the US dollar on world currency markets? With respect to the internal and external value of the dollar two types of evidence can be proposed.

(1) If the creation of a large supply of Eurodollars was indeed contributing to inflation in the United States, this should lead to a change in the long-term relationship between domestic money supply, real output, and prices. However, as Chart 1 shows, in the period 1957-1977 there would appear to have been only a slight change in the last two years in the relation between the quantity of money per unit of output on the one hand, and prices on the other. Leaving aside the supply of Eurodollars, this marginal change would be entirely explicable either in terms of the upward movement in income velocity (i.e. the decline in money balances relative to income) in the past few years of higher inflation, or in terms of the temporary reduction in output capacity following the oil crisis. The global supply of US dollars (M_{G2}) per unit of US output would therefore appear to add nothing to the explanation of the domestic US inflation rate which was not already provided by an examination of the behaviour of US money per unit of output.

(2) Turning to evidence of the value of the dollar in terms of foreign currencies, if the external purchasing power of the dollar had been reduced by the creation of an excess supply of dollars, this should result in a decline in the purchasing power of the dollar in terms of other currencies below its equilibrium rate as measured by traditional purchasing power parity ratios. Insofar as AMM has tested these propositions for the US dollar vis-a-vis the yen and the Hong Kong dollar (see p.25 and p.13), our findings are unequivocal: apart from short-term deviations, the exchange value of both the yen and the Hong Kong dollar can be reasonably explained in terms of relative price movements between the two economies under comparison. The corollary is that the exchange value of the US dollar is similarly explicable in terms of the relative inflation rates of the USA and other countries. The growth in the supply of Eurodollars, in other words, has not measurably contributed to the depreciation of the US dollar.

Conclusion: The creation and use of Eurodollars or Asian dollars is evidence of the supply and demand for US dollars as 'money' (or credit) outside the United States. Irrespective of whether the supply has arisen to meet demand for transactions purposes, for speculative purposes, or for other purposes, the question of whether the rapid increase in supply has exceeded the increase in demand is a matter for legitimate concern. In this article the hypothesis that the increase in supply of US dollars outside the US has undermined traditional measures of the internal and

external value of the US currency, hence contributing to inflation on the one hand and the depreciation of the US dollar on the other, has been considered in the light of two sets of evidence. While not denying the possibility that the holding of US dollar claims by a far greater number of people could be a destabilising influence in the short term, both sets of data tended to cast doubt on the validity of the theory. This finding is consistent with the view that the Euromarkets are analogous to the functions of specialised financial institutions providing various types of US dollar credit outside the Member Bank framework of the Federal Reserve System, and suggests that the rapid growth in the supply of Eurodollar deposits (and their counterparts: Eurobonds, and Eurodollar loans) represents a normal commercial response to the opportunities made available by the growth of world trade and by the gradual liberalisation of capital movements since the late 1950's.

In the absence of other evidence to the effect that the supply or demand for US dollars has been differentially affected by the growth of the Euro and Asian dollar markets, it is not possible to derive any normative conclusions as to the desirability of regulating the growth of the Euro-or Asian-dollar markets.

FORECAST: The value of the US dollar in terms of foreign currencies has only been marginally affected by the growth of Eurodollar and Asian dollar liabilities. The internal value of the US dollar - or the domestic inflation rate in the United States - for the remainder of 1978 has already been largely determined by the policies of the Federal Reserve since early 1975 when the systematic acceleration in M_1 and M_2 got under way (see Chart 3). The precise profile of US¹ inflation in 1978-79 will depend on a wide variety of factors, but there can be little doubt that the inflation has not yet run its full course, and probably has not yet peaked. So long as high rates of nominal spending in the US generated by historically high rates of monetary growth continue, the results will be seen in some combination of higher domestic prices and/or balance of trade or current account deficits leading in turn to a cheaper US dollar. Without assumptions as to the relative rates of growth of money in the US and other countries no precise prediction is possible, but without a pronounced change in either US monetary policy or the monetary policies of Japan and Germany, the weakness of the dollar relative to the yen and the DM will persist.

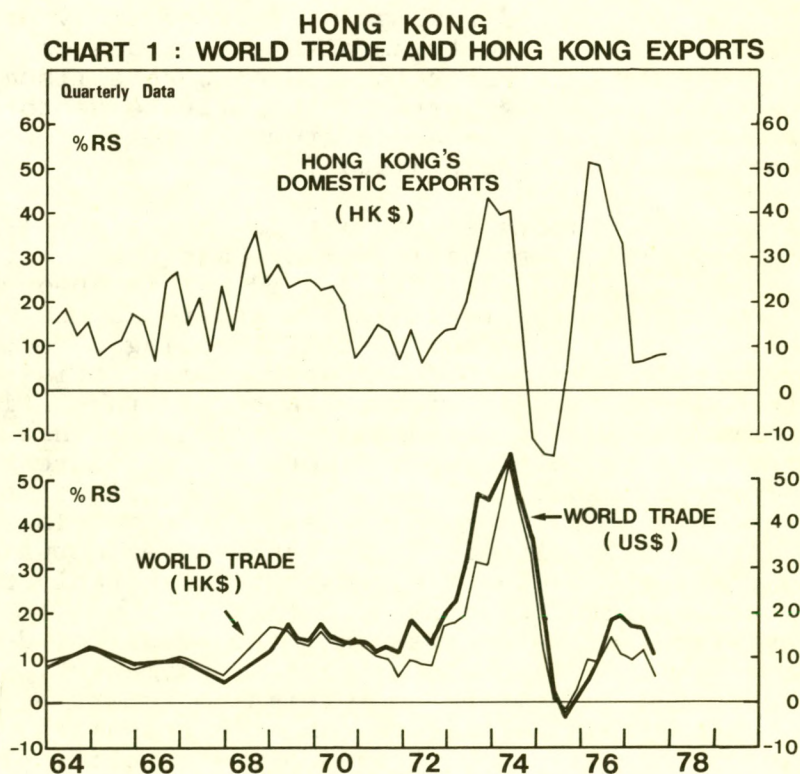
Naturally there will be temporary overshooting, at times aggravated no doubt by dollar sales from widely dispersed owners of US dollar claims, but the fundamental cause of the depreciation of the US dollar will remain in place just as long as domestic US policy continues overexpansionary. No amount of tampering with the Eurodollar market will relieve what is fundamentally a domestic problem.

HONG KONG

HONG KONG EXPORTS AND WORLD TRADE — AN UPTURN IN 1978?

Any prediction of Hong Kong's exports presupposes some theory of how the demand for Hong Kong's goods and services is generated. One frequently heard catch-all used to forecast Hong Kong's trade is the growth of world trade, but since world trade itself is simply the sum total of the imports of numerous different countries, in order to predict world trade one must in turn be able to predict with some degree of reliability the rate of growth of imports of each of those countries.

In Chart 1 we set out the rate of growth of Hong Kong's exports compared with the growth of world trade. It will be observed that since 1965 there have been three periods of markedly more rapid growth in world trade contrasted with three periods of slower growth - four if the current slowdown is included. Hong Kong's export performance slots into eight similar periods with the periods of slower growth being 1965-67, 1970-71, 1974-75, and the period since mid-1977, and the periods of more rapid growth being 1968-69 (which were also years of strong economic growth in the United States, Germany, and Japan), 1972-73 which were almost universally boom years, and the recent two year recovery phase between late 1975 and mid-1977. Broadly speaking the relation between Hong Kong's exports and the growth of world trade appears to be a close one - perhaps surprisingly close in view of the



World Trade: Imports (cif.) of all countries,
excluding USSR, Communist Bloc and Cuba.

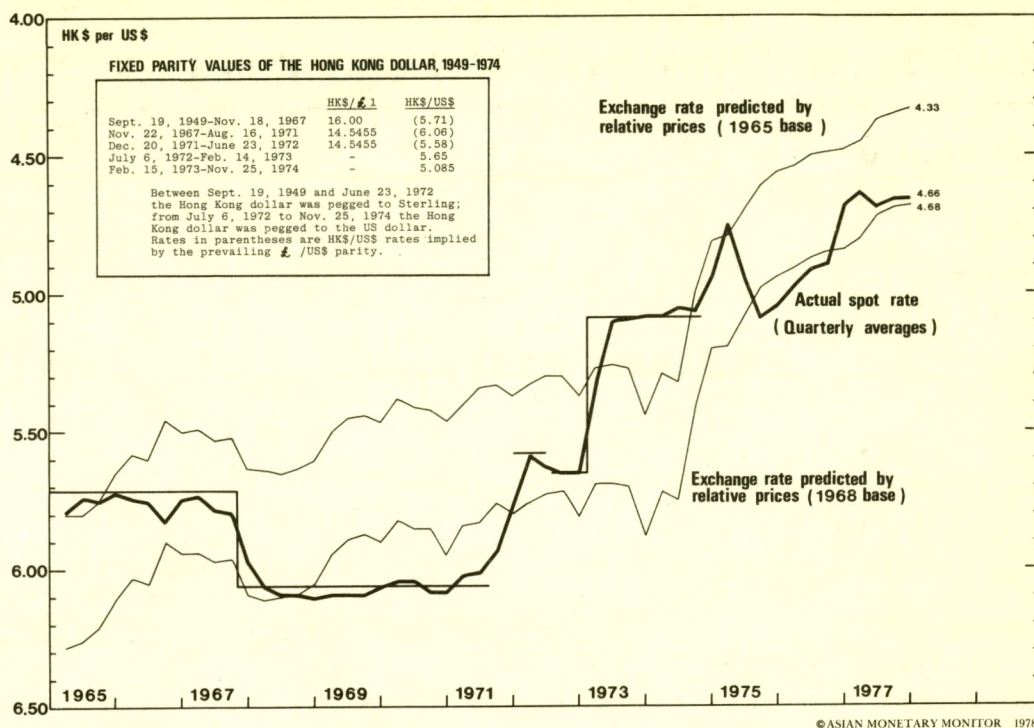
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fact that Hong Kong's exports are almost entirely restricted to manufactured goods whereas much of world trade is in commodities such as raw materials and fuel. However if a single theory could be found to explain both the level of commodity imports and the level of manufactured imports this would clearly be advantageous from the standpoint of predicting Hong Kong's exports.

In some countries such as the U.K. economic policy is conducted on the basis of the view (=theory) that if world trade can be expanded and if one's own country can only gain a larger share of that trade, economic recovery will follow. This theory goes on to prescribe that economic resources - labour, capital, and managerial skills - should therefore be deliberately channelled into exports or, as it is sometimes put, "into the balance of payments" by means of subsidies, incentives, taxes, special allowances, and other devices. As an extension to this theory it is argued that the way to achieve more rapid economic growth is for other countries to pursue similar policies that promote the growth of world trade as an end in itself. The economic hypothesis deriving from this analysis of the relation between world trade and economic growth is that the economy whose government manages domestic resources and demand so finely as to take advantage of the fluctuations of world trade will exhibit the most rapid real growth. Despite the close relation between Hong Kong's exports and world trade, the economy of Hong Kong does not fit happily into the classification suggested by this hypothesis. Firstly, there is almost no discrimination in Hong Kong's fiscal system in favour of exporters. Secondly, as to fine-tuning the fluctuations in the growth rate of the GDP, in the words of Hong Kong's Financial Secretary, the authorities "are powerless to moderate such fluctuations." Yet despite this Hong Kong has enjoyed rapid real growth. Conversely Britain, India, and Burma are all countries with a high degree of direct government involvement in exporting and elaborate fiscal incentives designed to promote exports by the private sector, yet all have suffered dismally low economic growth rates. How can these apparent contradictions be explained?

An alternative theory starts with a radically different analysis of the goals of economic policy, and goes on to propose a hypothesis which can be directly tested. This theory starts by pointing out that world trade is a means to an end, not an end in itself. Far from economic activity being directed to promote world trade, world trade is an economic activity which is justified only insofar as it contributes to the satisfaction of the ultimate demands of consumers. It follows that there is no need for a country to strive deliberately to increase its own share of world trade. If, as a by-product of satisfying the demands of consumers in other countries, the share in world trade of those who happen to live in a particular area actually increases, no doubt their economic growth will probably be more rapid than that achieved by others, but it will not be the result of government-inspired incentives, nor the result of deliberately channelling resources "into the balance of payments". There is, in short, no virtue in selling to foreign consumers - i.e. exporting - rather than selling to domestic consumers. It is this principle which underlies Hong Kong's overall policy of non-discrimination among industries and services.

HONG KONG
CHART 2 : ACTUAL AND PREDICTED EXCHANGE RATES



For a full explanation of Chart 2, see *Asian Monetary Monitor* Vol.1 No.1.

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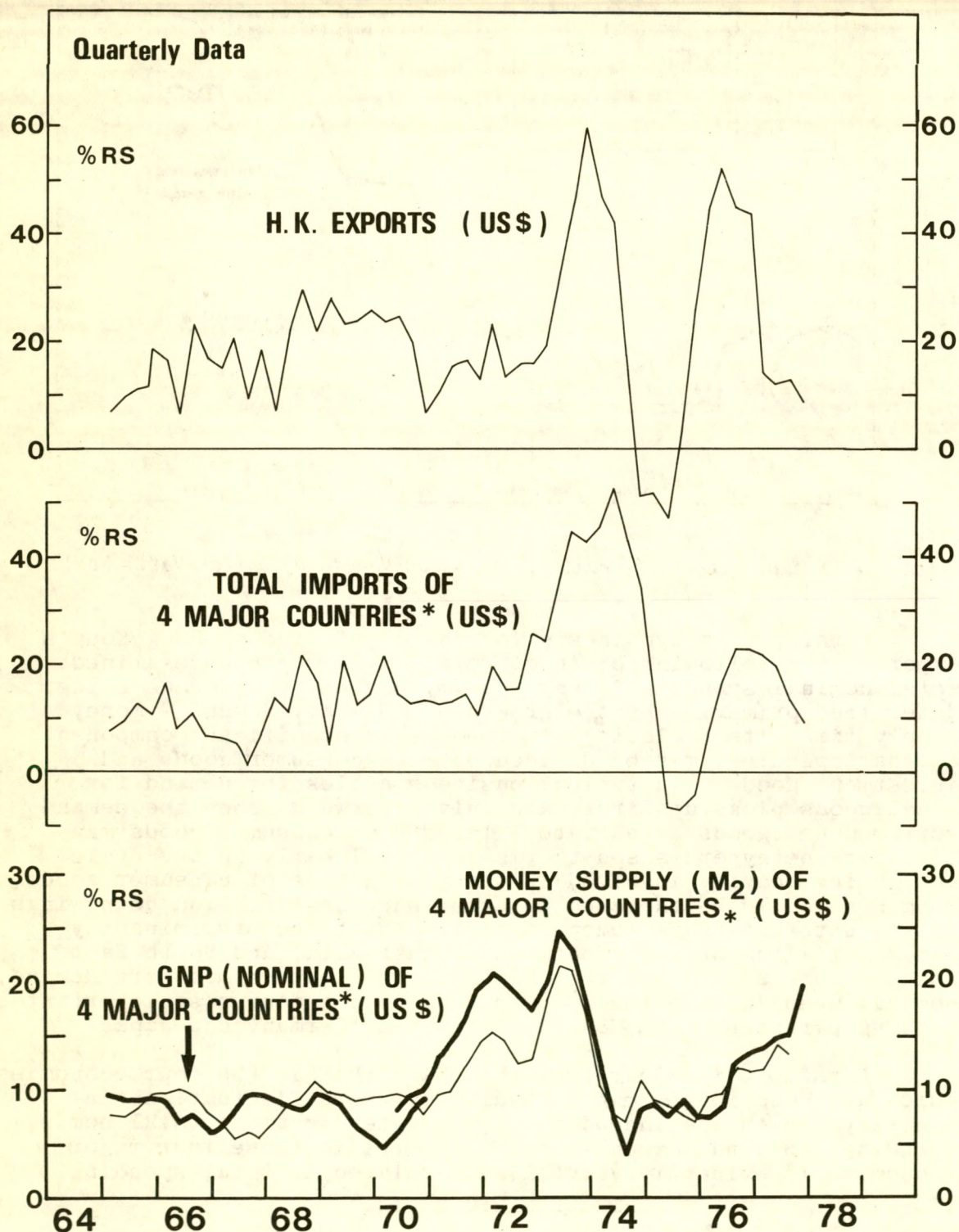
Turning to a hypothesis for the prediction of Hong Kong's exports, the following chain of relationships can be examined. Total nominal spending in any economy can be regarded as being determined primarily by the growth of monetary demand - money supply times its "velocity".* Imports, a significant component of that spending, may be divided between consumer goods and investment goods. In typical business cycles the demand for final goods picks up first, and only afterwards does the demand for producer goods accelerate. Imports of consumer goods may therefore be hypothesised to rise and fall early in the cycle, and, being heavily involved in the manufacture of consumer goods, Hong Kong could be expected to experience upswings and downswings in its external trade somewhat earlier than the predominantly raw-material exporting economies of Australia, and South East Asia. Chart 3 sets out the relationships between monetary demand, nominal spending and imports for Hong Kong's four most important trading partners - the USA, Britain, West Germany and Japan.

First, it is clear from the chart that in the four economies which are Hong Kong's major trading partners fluctuations in monetary growth are indeed a primary determinant of total nominal spending. Second, expenditure on imports in those four major economies is evidently very closely related to total spending.

* Annual income per dollar of money balances.

HONG KONG

CHART 3 : DETERMINANTS OF HONG KONG EXPORTS



* US, UK, JAPAN, W. GERMANY

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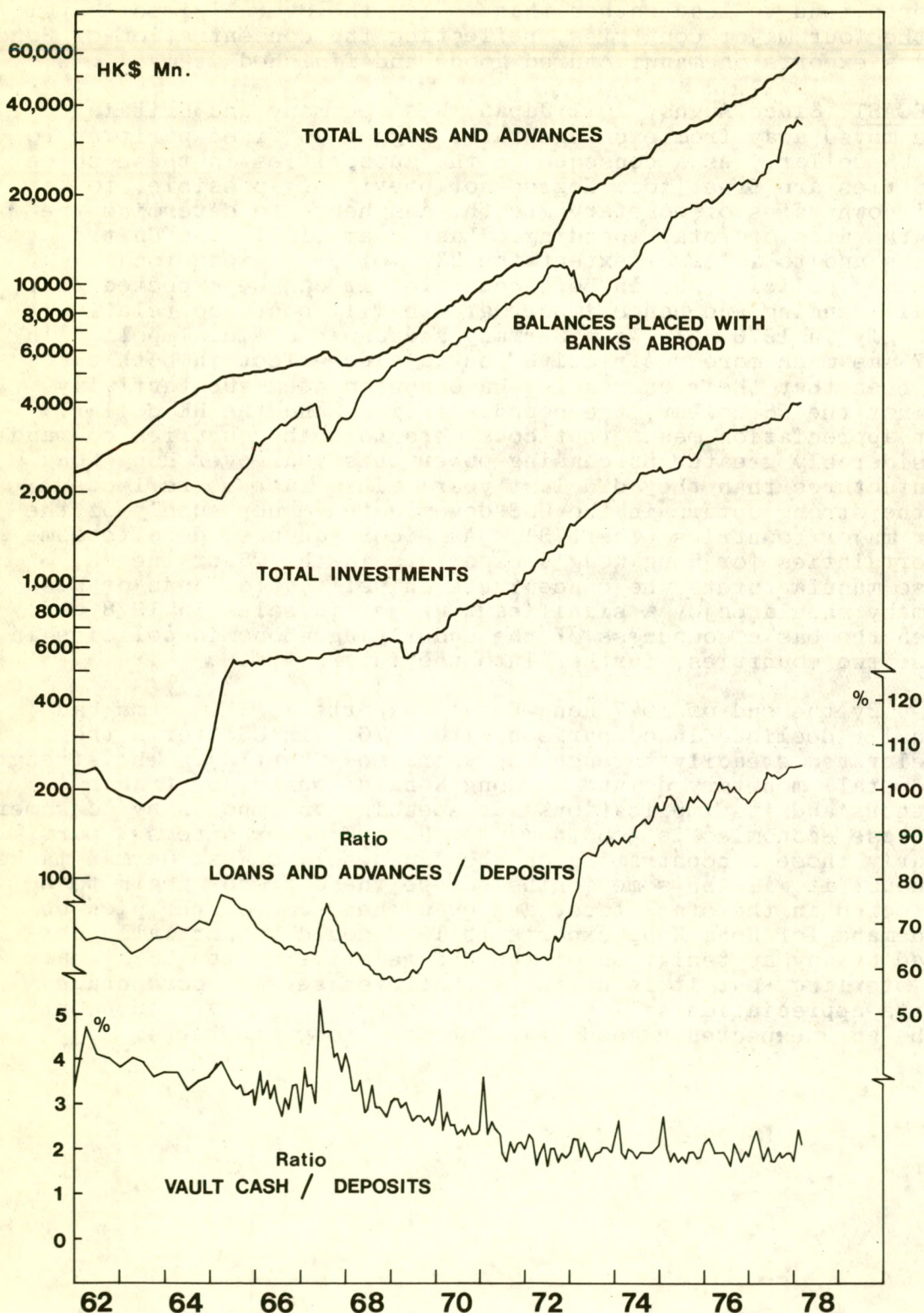
Third, Hong Kong's exports fluctuate in an almost precisely similar pattern to the imports of those four major economies. Fourth, as suggested by the hypothesis, fluctuations in Hong Kong's exports tend to lead rather than to lag the overall import cycle of the four major countries, reflecting the concentration of Hong Kong's exports on manufactured goods and finished items.

FORECAST: Since August 1971 Japan, West Germany and Britain have moved away from exchange rates pegged at fixed parities to the US dollar. As a consequence the authorities in these three countries are free, to a degree not previously possible, to set their own rates of monetary growth, and hence to determine the growth rates of total spending. Last year, 1977, the United States and to a lesser extent the UK, followed expansionary monetary policies and in both countries it can be expected that total spending and hence import growth will continue relatively strongly in 1978. In West Germany and Japan official policy in 1977 was much more restrictive, but a side-effect in both cases has been that their currencies have appreciated substantially against the US dollar, the pound sterling, and the HK dollar. That appreciation means that consumers in both countries command considerably greater purchasing power this year over Hong Kong's manufactures than they did last year. This fact is reflected in the strong upturn in the US\$ denominated money supply of the four major countries (Chart 3). As a consequence, despite some uncertainties for Hong Kong's exporters in the US or the UK, those manufacturers who concentrate on selling to Japan or West Germany should enjoy a significant upturn in sales in 1978 and, given the basic soundness of the underlying economic policies in these two countries, further into the future.

By the end of 1977 Hong Kong's exports in HK\$ terms had actually declined in comparison with 1976. In US\$ terms they decelerated steadily through the year (see Chart 3). The strength of overall monetary demand in Hong Kong's four major trading partners and its implications for spending on imports by consumers in those economies is good news for Hong Kong exporters - particularly those concentrating on the Japanese and West German markets. No doubt it will be some months before these trends begin to be reflected in the statistics, and even then some of the pick-up in demand for Hong Kong exports in 1978 could be partially obscured by any appreciation of the HK\$ relative to the US\$ (Chart 2) and sterling, but it is unlikely that even several percentage points appreciation will do much to dampen what could turn out to be an unexpectedly good year for Hong Kong exporters.

HONG KONG

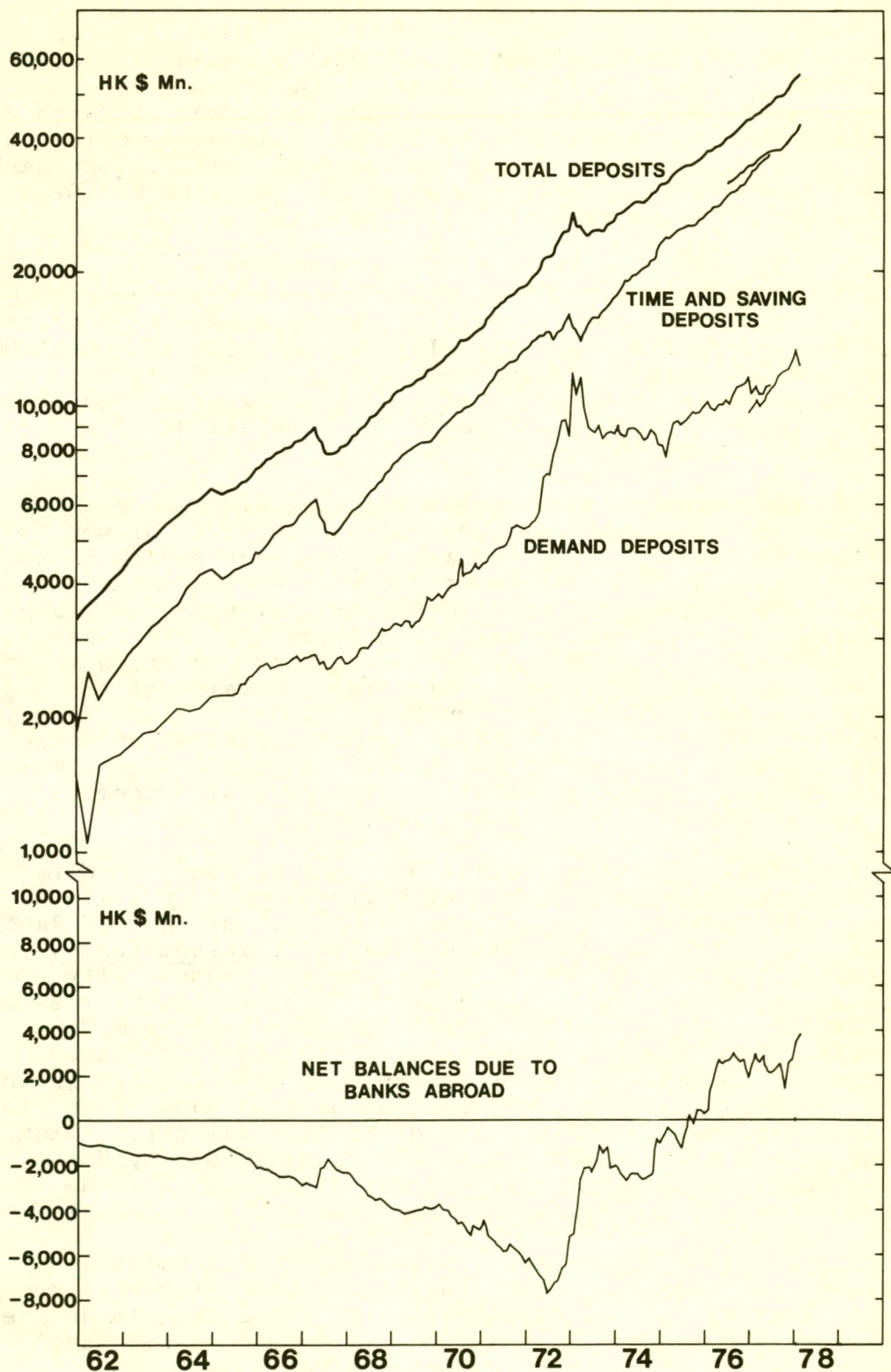
CHART 4 : BANK ASSETS



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HONG KONG

CHART 5 : BANK LIABILITIES



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JAPAN

AVOIDING THE MISTAKES OF 1972-73

In last two weeks of March the Bank of Japan purchased approximately US\$2.6 billion dollars in the Tokyo foreign exchange market before withdrawing from the market on March 29, indicating that there would be no further attempt to offset the appreciation of the yen. Following the withdrawal of the Bank of Japan from the market the yen moved sharply from 225.02 on March 31 to a closing rate of 218.20 on April 3.

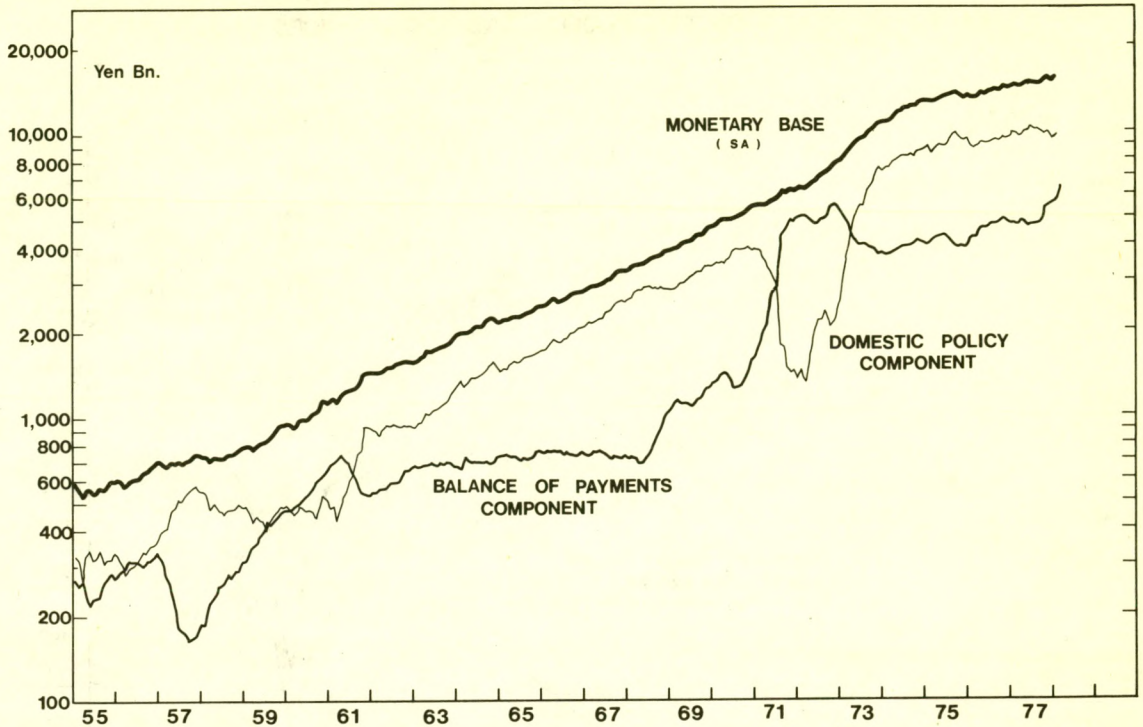
In 1971, 1972 and early 1973 similar dollar support operations were associated with a huge increase in the Bank of Japan's foreign exchange reserves and an accompanying acceleration in the rate of monetary growth. In 1978 the size of recent BOJ support operations has led to concern that once again the authorities' attempts to peg the yen/dollar rate may result in an undesirable monetary expansion. Is there evidence to justify such fears?

The charts opposite show how the Bank of Japan's acquisition of US dollars has been almost entirely offset by reductions in credit to the banking system and credits to the government. In U.S. dollar terms Japan's foreign exchange reserves have increased sharply over the past year, but in yen terms their value has not changed significantly. In these charts Gold and Foreign Exchange reserves are converted to yen at prevailing exchange rates to give the yen value of the foreign component of the monetary base. This is in contrast to the Bank of Japan's formal accounting procedures which value foreign exchange reserves at the so-called 'Basic Rate', which was set at the Smithsonian parity of Yen308 until December 1977, and at Yen262 since January 1978.

In addition to reducing its outstanding loans to City Banks and reducing its holdings of Kaibre-tegata (private sector bills purchased for its own account), the Bank of Japan has also reintroduced an instrument called Uridashi-tegata (literally, bills sold for its own account). Essentially promissory notes issued by the Bank of Japan to the City Banks, sales of these bills have the effect of absorbing from City Banks any excess reserves which they would otherwise have acquired due to Bank of Japan purchases of U.S. dollars in the foreign exchange market. In April the Bank of Japan plans to sell approximately Yen200 billion of the special notes which, in conjunction with reductions in its credits to City Banks, is calculated to be enough to eliminate the surplus of funds in the money markets due to BOJ intervention and to seasonal factors.

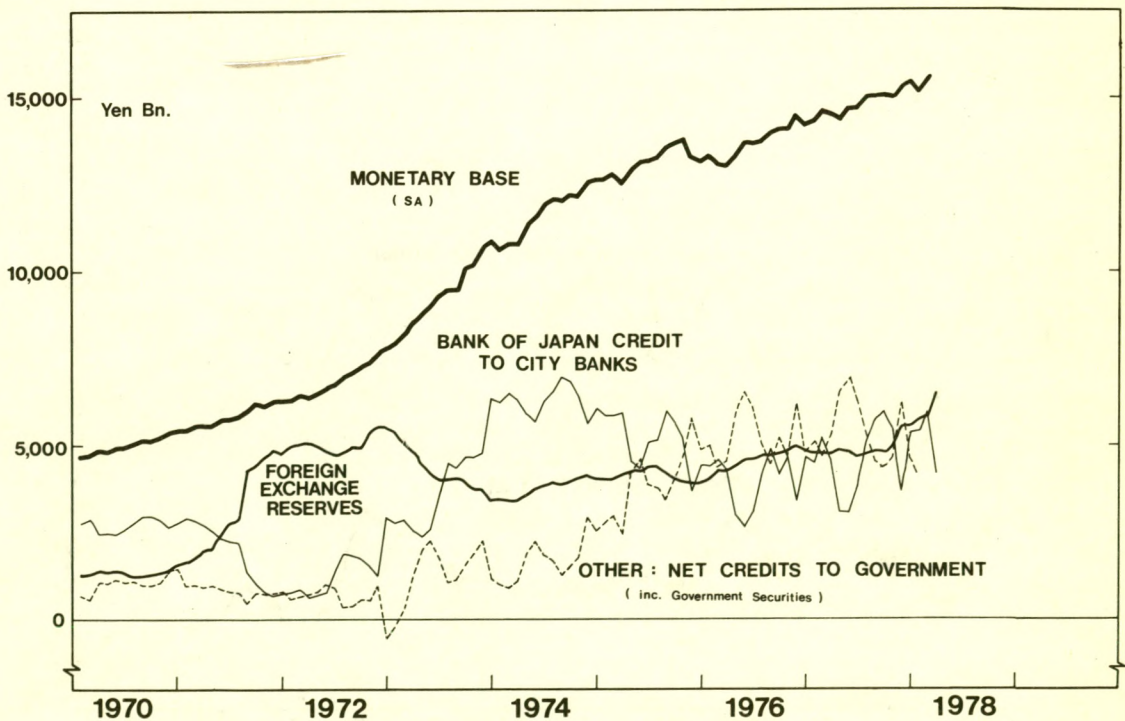
All of these developments may seem exceptionally technical, as indeed they are, but the measures taken by the Japanese authorities are illustrative of the switch in Japanese monetary policy described in AMM Vol. 1 No. 1. Having been persuaded by the statistical evidence as well as by the experience of the early 1970s that excess monetary growth was the underlying cause of inflation, the authorities are now determined to avoid the mistakes made in 1972-73 when intervention

JAPAN
CHART 1 : MONETARY BASE AND COMPONENTS



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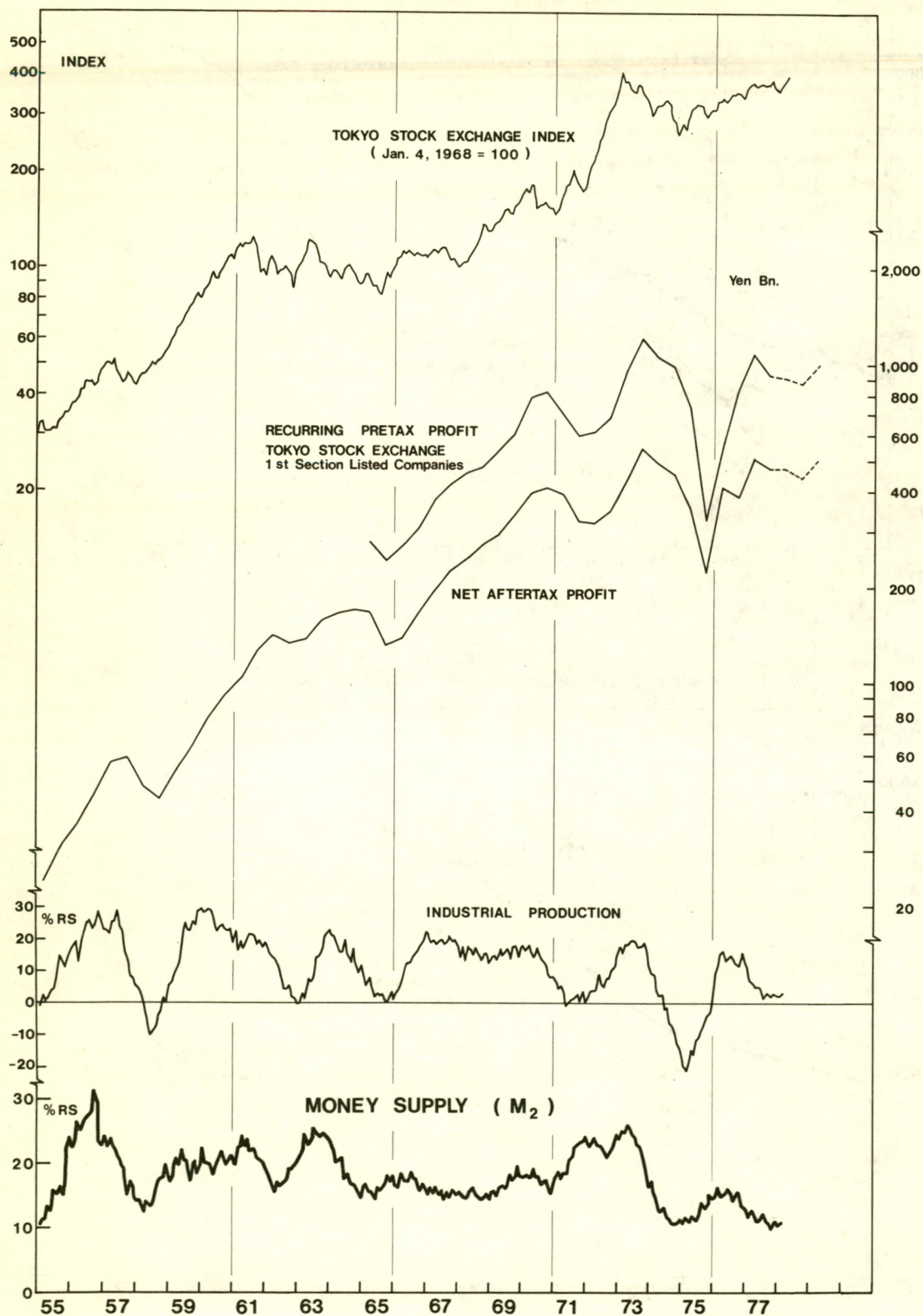
JAPAN
CHART 2 : SOURCES OF THE MONETARY BASE



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JAPAN

CHART 3 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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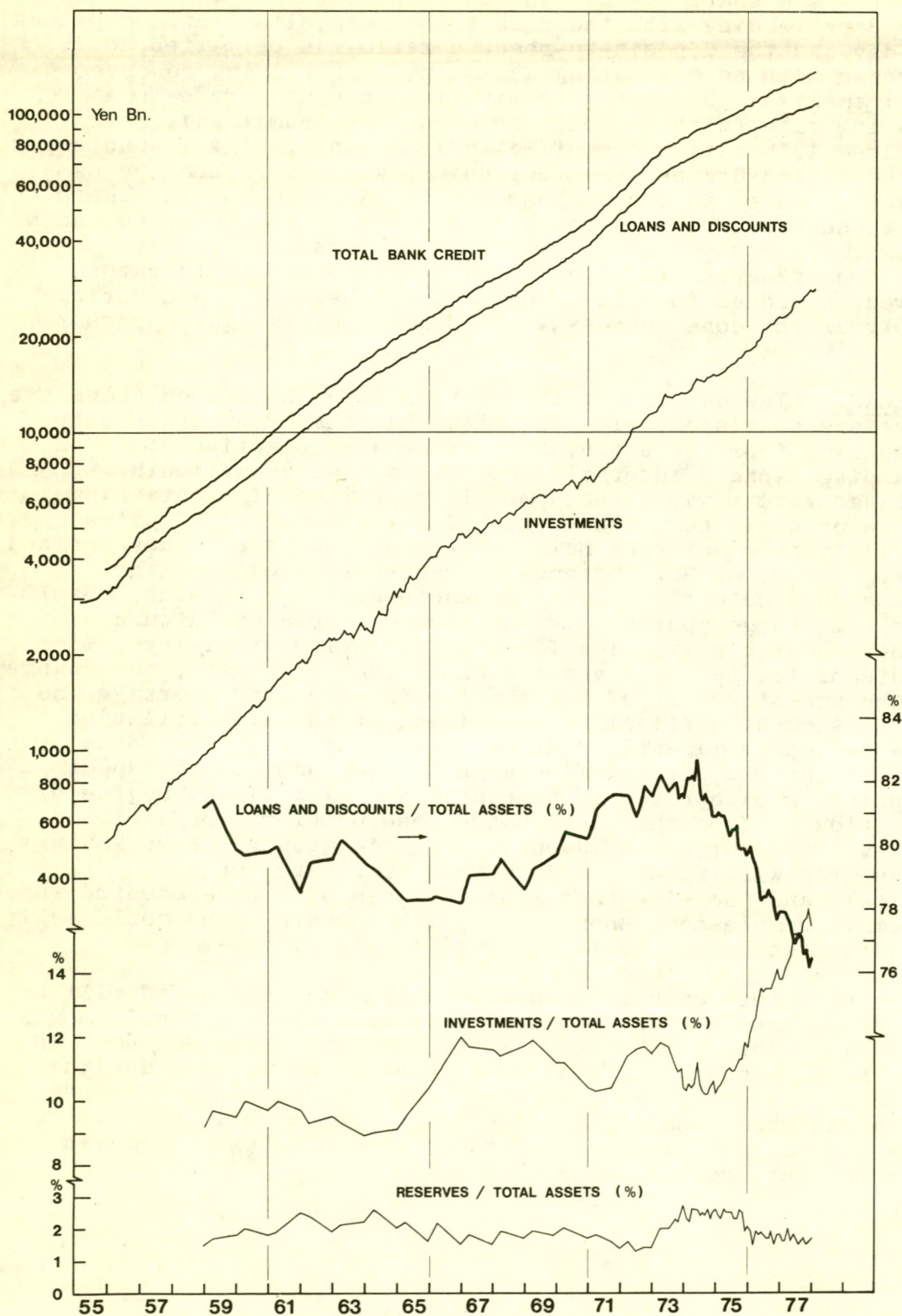
in the foreign exchange market compounded the errors that had already occurred in 1971. (In that year the primary error was not failure to offset intervention in the foreign exchange market - see Chart 2 - but the failure to keep a tight rein on City Bank lending, with the result that deposits grew exceptionally rapidly and the deposit-to-reserve ratio was permitted to increase with no offsetting action such as raising reserve requirements). By moving from a fixed exchange rate to a floating rate (with periodic intervention, admittedly), the Japanese authorities are effectively saying to their counterparts in the United States that they do not wish to pursue the same inflation rates as those chosen by the American policymakers. For those who were in a position to examine the evidence, such a statement was already implicit in the monetary policy enforced in Japan since early 1977 when money growth rates slowed to around 10 percent per annum (Chart 3), and during this year the consequences will become increasingly apparent.

FORECAST: The actions of the Bank of Japan described above are therefore consistent with the view that the authorities have moved away from the essentially external objective of balancing Japan's international payments at a particular exchange rate towards the domestic objective of maintaining stable prices. The method selected for attainment of price stability is consistent ~~with~~ steady growth of the broadly-defined money supply, or M_2 . Without a precise knowledge of the real growth potential of the Japanese economy, however, the 10-11 pct M_2 target pursued by the Bank of Japan could turn out to be too high or too low for absolute price stability. If events of the past few years such as the oil crisis, the change in the age-structure of the population, the land shortage and the consequent difficulty in building productive facilities have indeed permanently reduced Japan's capacity for real economic growth, as is often argued, then one should expect 10-11 pct M_2 growth rates to be consistent with a mild degree of inflation. If on the other hand those problems are a mirage, and the real springs of Japan's economic growth - high savings rates, the willingness to invest in human and non-human capital, and the risk-taking preferences of Japanese entrepreneurs - remain unmolested, then 10-11 pct M_2 growth rates could well be consistent with declining overall price levels.

As a test case in economic theory the year ahead will be extremely interesting: all the signs point to a strong domestic economic recovery in Japan, yet at the same time, consumer and wholesale prices are likely to continue flat or even decline. There are very few examples among major economies in the post-war world where declining prices have been experienced at the same time as positive real economic growth rates, but Japan in 1978 may yet prove to be such a case.

JAPAN

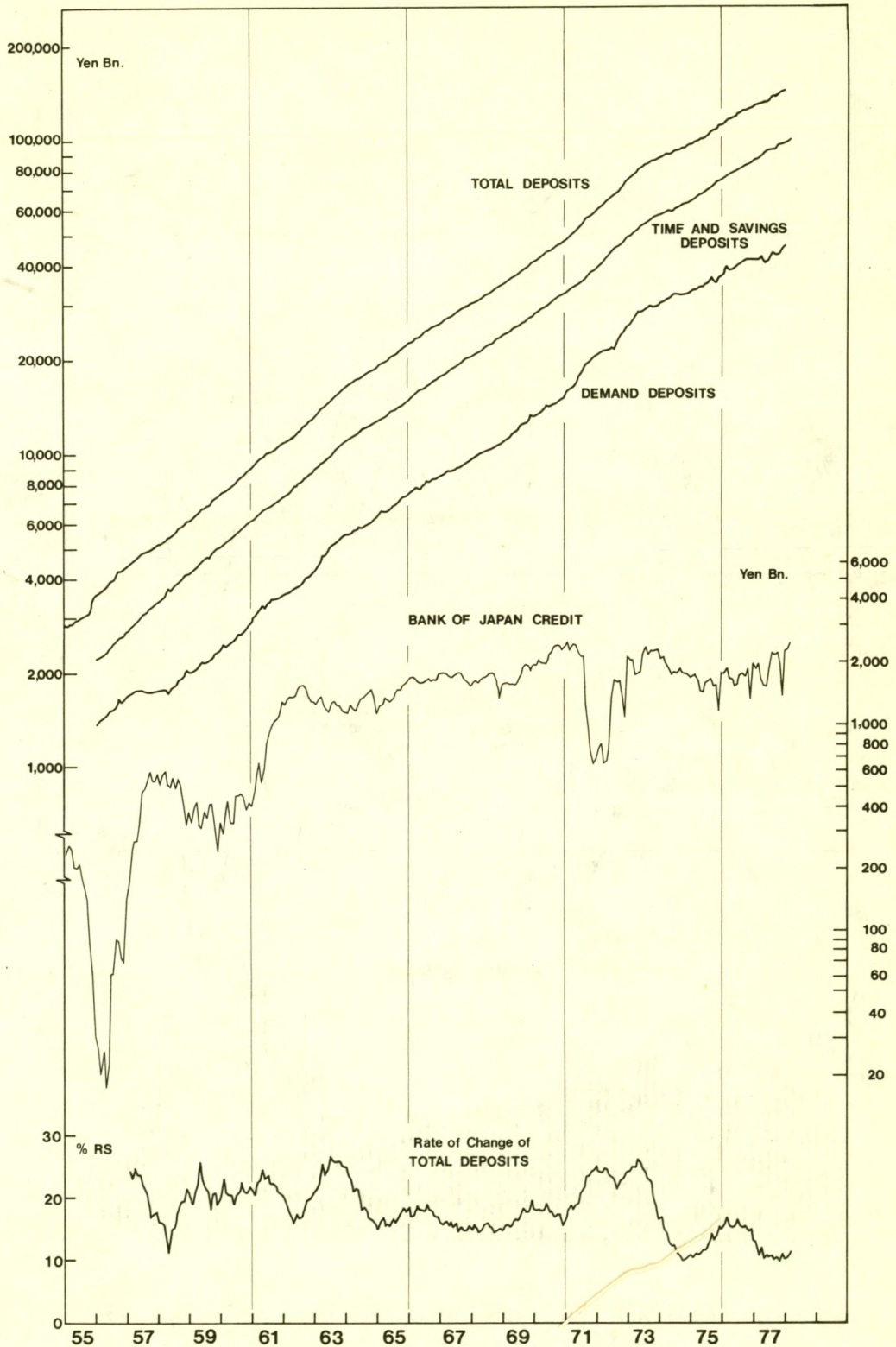
CHART 4 : BANK ASSETS



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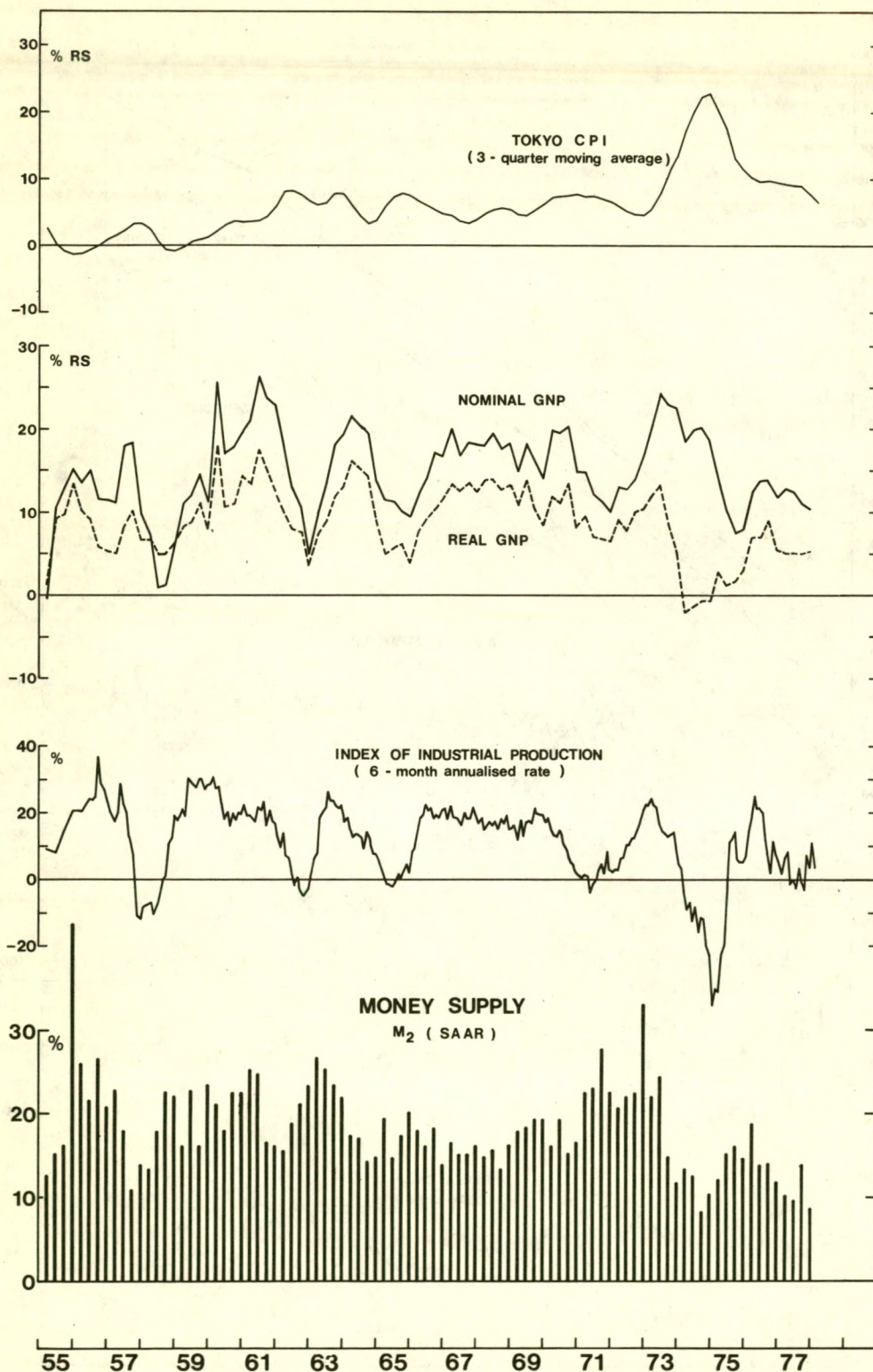
CHART 5 : BANK LIABILITIES



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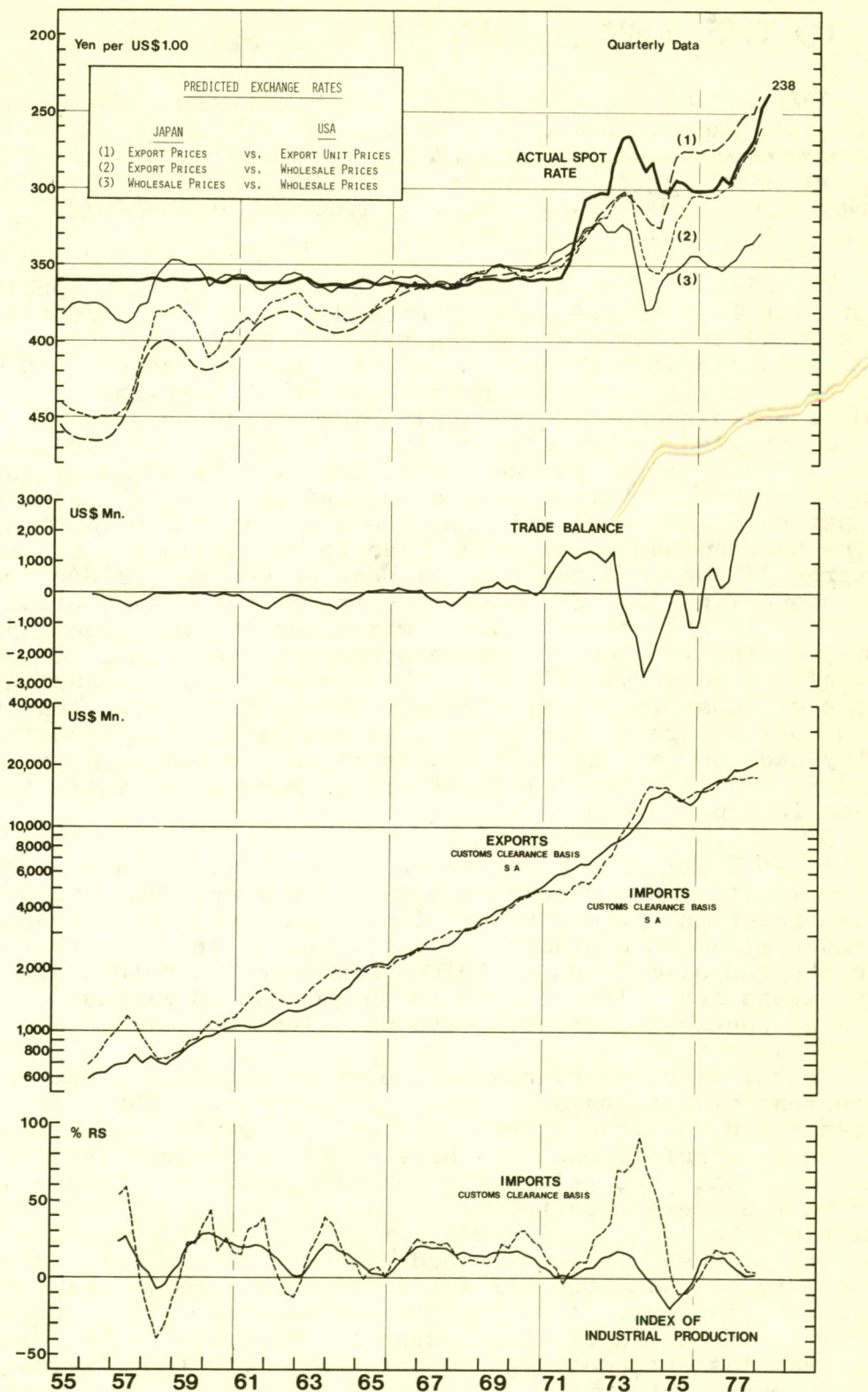
CHART 6 : MONEY, OUTPUT, AND PRICES



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JAPAN

CHART 7 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



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EPISODES FROM ASIAN MONETARY HISTORY

INDONESIA UNDER SUKARNO : TO THE ABYSS AND BACK (Part 1)

This is the first of two articles which will examine the economic and financial plight of Indonesia up to 1966. In this article the causes of the rampant inflation are discussed, in particular, the degeneration in the government fiscal budget. Finally we describe the drastic attempt to reduce the money supply in 1959 which brought the country to a standstill.

The history of Indonesia from the birth of the Republic on August 17th 1945 to the fall of President Sukarno in 1966 is a tale of neglect, waste and degeneration. Year after year the normal economic activity of the country was subjected to disruptions and interference by a government which thrashed about in exploits which became increasingly bizarre and grandiose. While Sukarno exhorted his people to 'throw themselves on the log-fires of revolution' and to pursue revolution 'to the abyss of annihilation' economic activity stagnated, inflation accelerated and real per capita income declined. Despite his flamboyant exhortations Sukarno had no coherent plan to revolutionise his country. He expressed contempt for cold-blooded economics and declared that Indonesians 'ran on emotion'. Yet it was his complete failure on the economic front which was to be his undoing. It became manifestly clear to the people that the dismal economic state of the country was due to the irresponsibility and incompetence of those in power. The government did indeed lead the people to the edge of the abyss of annihilation; in 1965 the country had lost all her foreign reserves, economic activity ground to a halt through lack of vital imports and inflation soared to over 100% per month.

It is difficult to imagine how things would have gone on had the military not displaced Sukarno in 1966. The imposition of firm government where before there had been only corruption and indecision had a dramatic effect, and in the four years since the end of Sukarno's 'Guided Democracy' Indonesia recovered to an extent scarcely credible to those who had witnessed the preceding decades of economic and political turmoil.

In relating the events of the whole period the peculiar environment of Indonesia must be borne in mind. The inflation in Indonesia had far less effect on the lives of most of her people than the hyperinflations that have occurred in more developed countries. Only the relatively few middle class citizens and the urban poor suffered severely from the inflation. The rural population who in any case held very little money continued to live their lives much as they had always done. Their dependence on monetary transactions was small and they were largely self-sufficient in food. They had few assets whose values were fixed in nominal terms and the Indonesian's propensity to hold liquid assets remains extremely low to this day. For the millions in the Javanese countryside, in Bali, in Sumatra or the thousands of other islands, the main impact of the economic collapse was the deterioration in the transport and communications system and the

shortage of supply of some durable goods and imports. It was the modern sector - the embryonic manufacturing industries, the financial system, the civil servants and the urban working people who suffered most. Pick's Currency Year Book in reviewing the sad record of the Rupiah aptly summed up the first twenty years of the life of the Republic:

"The Rupiah has embodied an amazing history of abominable economic mismanagement, flagrant graft and corruption, violent domestic strife and dissension, gigantic waste of foreign credits and their blatant misuse for extravagance, military and political adventures, unending budgetary deficit, practically unlimited utilization of printing presses for turning out Rupiahs, soaring prices and an incredible debasement of the monetary unit leading to national bankruptcy."

Yet, before the war Indonesia had had an efficient administration, prospering trade, and a stable currency. The Dutch had ruled the colony with stern efficiency, and for many years large sums had been repatriated to the Netherlands whose financial condition had not been so sturdy. By 1930 nearly a quarter of a million Europeans and Eurasians were working in the Indies and total Western investment in the colony had reached an estimated 2,000 million US dollars, but already there were signs of discontent among the Indonesians. In the 1930s the first nationalist movements were vigorously suppressed, but during the war Sukarno's Indonesian Nationalist Party prospered by collaboration with the Japanese occupying forces. It was not surprising therefore that the Dutch refused to recognise the fledgling republic which Sukarno announced to the world immediately the Japanese withdrew from the islands. To the Dutch Sukarno was a criminal and the Nationalist Party's cooperation with the Japanese overshadowed the fact that legitimate and spontaneous nationalist feelings were widespread in Indonesia.

For four wearing years the Dutch fought to recover the colony, but though the outer islands were readily subjugated Java held out. As the Dutch economy rapidly recovered from the wartime occupation and world sentiment turned against colonialism, Dutch enthusiasm for the war waned and after the British had granted independence to India in 1947 it was only a matter of time before other colonies were given away. The United Nations brought increasing pressure to bear on the Dutch to grant full independence after which in December 1949 sovereignty was formally transferred.

Sukarno remained president of the republic, but whereas before 1950 he had had virtually unlimited powers, his role was now restricted to that of a constitutional head of a parliamentary democracy. For ten years Sukarno itched to recover his former power: by deft political manoeuvring and rousing rhetoric he identified himself with the true Indonesian nationalist feelings of the people. He boasted:

"Why is it that the masses beg me to speak to them? Because they want to hear their own thoughts, which they cannot yet formulate themselves."

The parliamentary democracy was a disaster. Grossly overlarge political assemblies and a proliferation of political parties representing every permutation of race, region, and religion engaging in interminable internecine struggles meant that Cabinets when formed were weak coalitions, indecisive and unstable, and quite unable to stand up to the army, the President, or the communists. Part of the problem was that Indonesia consisted of a multitude of islands which supported different ethnic and religious groups, who increasingly resented the dominance of Java in Indonesian politics. Java was the most densely populated island and was growing more and more dependent on the outer islands to provide the income and exports to support it. To them Java was a parasite. As one ministry followed another in quick succession it became increasingly apparent that the peoples of Indonesia had been united only in their opposition to the Dutch colonial rule and now that they had gained independence a democracy seemed incapable of giving them either leadership or direction.

The Post-War Economy

Against such a political background little was done to restore the administration and infrastructure which had deteriorated since the Japanese occupation. Statistics from Indonesia in this period are not very reliable but generally portray stagnating or declining output. Agricultural production of most commodities was probably considerably below prewar levels throughout the 1950s. Most notably the neglect of the rubber plantations led to declining yields - a trend which the process of replanting could not halt for many years. Adding to Indonesia's problems was the rapid growth of the population which overtook rice production in the mid 1950s and thereafter year by year imports of rice increased, so that today Indonesia is the world's largest importer of rice.

PRODUCTION FROM AGRICULTURAL ESTATES

(M/ Tons)	Rubber	Coffee	Tea	Cin- chona Bark	Palm- oil	Hard- rope fibres	Cane sugar
1938	175,078	45,479	80,538	10,955	226,668	40,767	1,375,510
1951	226,383	12,055	46,513	9,080	121,147	16,581	427,059
1952	299,387	13,248	37,277	3,803	146,351	32,182	460,264
1953	309,185	22,408	37,039	1,204	160,494	27,809	619,829
1954	288,188	14,445	46,930	1,797	168,701	31,331	717,712
1955	266,588	16,053	43,995	2,656	165,806	35,600	852,299
1956	265,994	13,021	42,931	2,251	164,896	35,175	785,723
1957	258,494	15,284	47,570	3,488	160,153	32,847	828,451
1958	244,113	15,574	46,580	4,091	147,850	27,082	774,563
1959	245,736	18,861	44,178	3,748	137,423	22,498	835,196

Source: Central Bureau of Statistics, Djakarta.

The Indonesian economy was essentially agrarian, the major export commodities were agricultural products, the major sectors in the economy were agriculture and services. Manufacturing was insignificant and mining activities - while important for exports - used relatively little manpower. Very little was done by the government in the first fifteen years of the life of the republic to promote economic development in the islands and the proportion of government expenditure devoted to development was minute. Indonesia suffered not only from a tragic neglect of practical development plans but also from a neglect of the upkeep of the economy's infrastructure. Little was done to improve inter-island communications, the railways or the roads and in the 1960s the State airline was fully occupied in transporting government and military personnel and the railways in transporting raw materials for government projects.

The economic decline, the acceleration in inflation the balance of payments crises and the eventual downfall of Sukarno were the culmination of a process which began at the very birth of the republic. Inflation initiated by government deficit spending rapidly took root in the enfeebled economy and by its dislocating effect on the administration and trade became self-sustaining and reinforcing. Broadly the economic degeneration of Indonesia can be divided into three phases corresponding roughly to the rates of inflation experienced in each, but also fortuitously corresponding to three phases in economic policy.

1) The first period from 1950 to 1959 is the period of parliamentary democracy. The administrations were weak and though generally filled with good intentions they nevertheless paved the way to hell. The government budget was continually in deficit but there were occasional attempts at reform of the administration and the tax and monetary systems. All the causes of the inflation were incipient in this period: the budget deficits, the foreign exchange system, and corruption were all present, but inflation itself was comparatively mild - only accelerating to over 30% per annum in 1958 and 1959.

2) The period from 1959 to 1965 was the era of the infamous 'Guided Democracy' under which the exercise of power became despotic and the government attempted to bring the entire financial and trading sectors of the economy under its control. The rate of inflation was always over 100% per annum after 1961 and the balance of payments deficits rapidly exhausted the foreign reserves of the country. In 1965 an attempted communist coup was countered by a military takeover which brought the Sukarno era to an end.

3) The third period was one of recovery; in only two years the military regained control of budget spending and the rate of consumer price inflation was brought down from over 100% per month in 1966 to less than 10% per year in 1969. Though inflation was at its height in 1966 it was nevertheless the year when recovery began.

THE CAUSES OF INFLATION

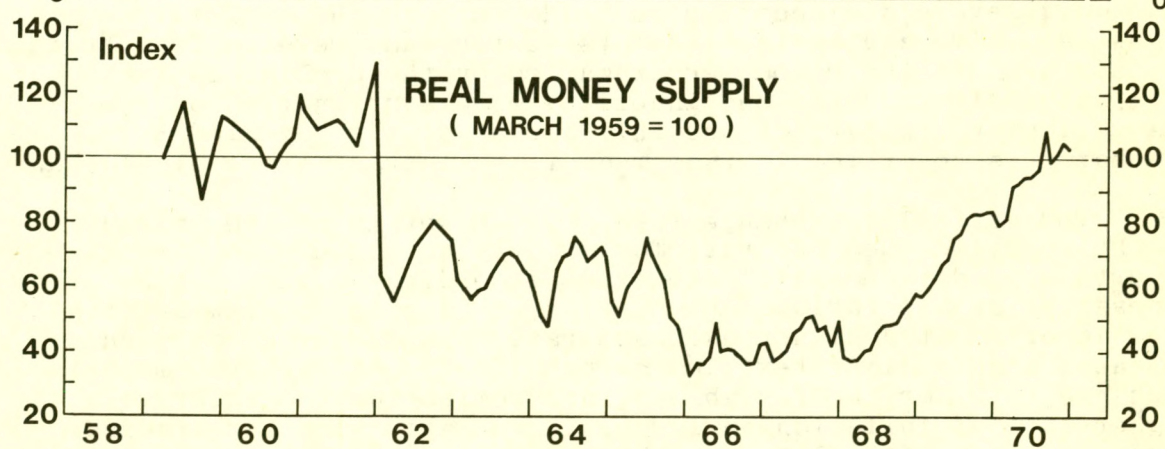
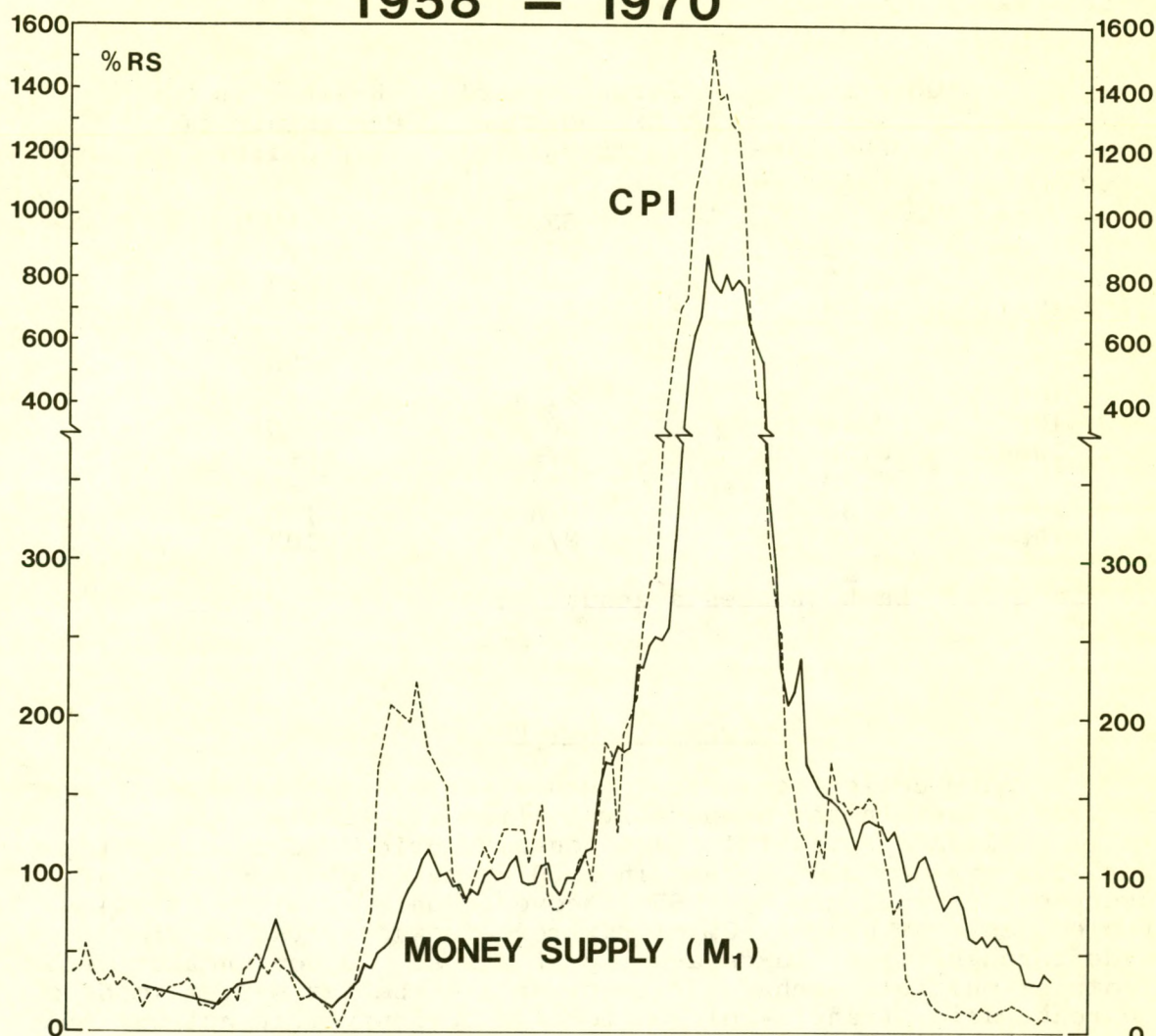
The Indonesian inflation arose from the inability of the government to finance its expenditure without recourse to the printing of money. Thus, the inflation was caused by a failure to control expenditure, from the failure to collect sufficient taxes and from the inability to borrow money to finance the resulting gap between revenue and expenditure. Each of these three factors was important.

Government Expenditure

The central government budget was in deficit every year from 1950 till 1968. Particularly in the later period when the inflation was at its height the deficits arose more from a breakdown in the tax system than from extravagant government expenditure. The total amount of government expenditure was never more than 20% of GNP and was usually less than 15% of GNP. Although this was rather high for such a poor undeveloped country to finance internally, it was no higher than in most other South East Asian nations at that time. What was more reprehensible was the inappropriateness of the government spending. Little was spent on health and education or infrastructure projects while vast amounts were spent on the armed forces. In the early 1950s 'security' accounted for nearly half of government expenditure. The army had grown in size and achieved great influence during the revolutionary war and all subsequent attempts to curtail its size or autonomy were fiercely resisted. Insurrections occurred throughout the 1950s and the role the army played in suppressing the rebellions and maintaining law and order further helped to maintain its privileged status in Indonesian politics. One incident in particular illustrates the political power of the army. In October 1952 the Minister of Defence and the Finance Minister proposed to reform the army by reducing its size and transforming it into a small modern fighting force equipped with the help of Dutch military aid. Opponents of the scheme roused popular sentiment against the measures, a vote of no-confidence in the Defence Minister was passed in the provisional parliament, and a menacing formation of army units drew up outside the Presidential palace. In the face of such opposition the Defence Minister had no choice but to retire and the cabinet itself came to an end a few months later.

Yet, despite the widely held belief that profligate military expenditure was the cause of the budget deficit the share of defence spending in total government expenditure declined somewhat until 1960. Only in 1960 and 1961 would it be possible to argue that expansion of military expenditure contributed significantly to the budget deficit. Although 54% of expenditure in 1962 was devoted to defence, the real value of defence expenditure fell by 43%. It is quite clear particularly in the late fifties and early sixties that the budget deficits arose chiefly because of the lack of effective fiscal control. Real expenditure fell by over a third in the early sixties as civil service wages and

MONEY AND PRICES IN INDONESIA 1958 - 1970



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government expenditure plans were overtaken by the wild acceleration in prices, but government revenue also failed to keep up with the rate of inflation after 1961 so almost all budgetary control was lost.

	Government Real Expenditure 1958 = 1.00	Percentage of Expenditure on 'Security'	Revenue as Percentage of Expenditure
1958	1.00	37	62
1959	1.02	37	65
1960	1.12	42	83
1961	1.23	46	70
1962	0.60	54	62
1963	0.75	28	49
1964	0.78	21	41
1965	0.74	20	36
1966	0.58	N/A	43
1967	0.83	N/A	96
1968	0.85	N/A	100
1969	1.08	N/A	103

Source: Bank Indonesia Annual Reports

Government Revenue

Revenue collection proved even less robust than expenditure. Never efficient in the comparatively tranquil fifties, the tax system collapsed completely once consumer prices were increasing over 100% per annum. Whereas in 1959 Revenue covered 2/3rds of government expenditure by 1965 it covered only a third. A major problem was that around 50% of tax revenue was extracted from trade through import taxes and export taxes. In conjunction with a complex multiple exchange rate structure the tax system imposed a bureaucratic strangle-hold on foreign currency transactions which caused a severe disincentive to trade through the official channels. Time and again, attempts to increase revenue from trade by increases in tax rates were thwarted by the decline in the real value of trade and the inability or disinclination of the tax collectors to extract the full amount of tax payable. Moreover the barriers to official trade made illegal trade extremely lucrative.

The multiple exchange rate system set up at the birth of the republic used one rate for exports and others for imports. Imports were divided into categories according to the 'degree of necessity' of the various commodities, thus rice and raw materials were imported at a higher exchange rate than luxury goods such as cars, high quality textiles or baby food. As the free-market exchange rate for the rupiah declined reflecting the relatively higher rate of inflation in Indonesia compared with her trading partners, the official rate would be revised or subjected to surcharges, the number of import categories would be increased,

the 'export bonus' scheme would be tinkered with, and tax rates altered. The tendency was always to elaboration rather than simplification, and the whole cumbersome structure grew more unwieldy and confusing over time. Periodically 'major' reforms took place, consolidating intervening legislation and resetting the official base rate at a new level. As inflation accelerated such reforms became more frequent, but the fundamental concept of multiple exchange rates was left intact so that by 1965 the foreign exchange regulations were so bureaucratic and so severely distorted the market pricing mechanism that much of the foreign exchange legislation was unenforceable and flagrant violation of the regulations was widespread.

Official trade statistics are very poor for this period but they indicate that exports grew little in real terms before 1966. Exports in 1951 were barely half of the quantity in 1938 and still had not recovered their prewar level fifteen years later. Between 1960 and 1966 the value of recorded exports declined from US\$841 million to US\$679 million per year. In contrast, not only were the incentives for illegal trade very strong but they increased during the period under consideration.

C.G.F. Simkins in the Bulletin of Indonesian Economic (March 1970) estimated the incentives to illegal trade. In 1958, for every dollar of foreign currency earned through official channels the exporter could buy only 40 cents worth of foreign goods. Though the ratio improved gradually until in 1966 he could obtain 73 cents worth of foreign goods, in the meantime the disparity between the official exchange rate and the blackmarket rate had widened considerably, so that even though the dollar returns to legal trade had increased the returns to smuggling had risen far more rapidly. The rupiah returns from illegal exports (ignoring smuggling costs) were equal to three times the returns from legal exports in 1958 but in 1962 they earned seven times as much as legal exports, and the gap widened even more in later years (see next page).

Given such strong incentives to illegal trade and the difficulty of patrolling the thousands of islands of Indonesia it is not surprising that an enormous amount of smuggling went on and this would partly explain the fact that the dollar value of recorded exports dwindled from around \$800 m. in the late fifties to under \$700 m. in 1966 and 1967. Tentatively Simkins estimates that unrecorded trade equalled 20% of the total trade in the period 1958 to 1962; for some individual commodities his estimates are much higher, unrecorded exports of copra and coffee equalled over 40% of total exports of these commodities in the same period.

It was not surprising therefore that official sources incessantly blamed the budget deficits on the loss of tax revenues from illegal trade, and - to the extent of which they were correct - they had only themselves to blame.

The failure of the bureaucratic foreign transactions mechanism to keep up with market forces led to a huge disparity between official and unofficial returns to trade and thereby created tremendous opportunities for graft and corruption. Regional army commanders, in overt collaboration with illegal traders and even embarking on various enterprises of their own, not only made money for themselves but also for local political factions disenchanted with Javanese domination of the Republic. In addition the produce from the many large estates owned and run by the army more often than not left the country without too much official scrutiny.

Incentives to Unrecorded Trade 1958-1966

	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>
Exchange rate Rp/\$									
Free Market									
(Year average)	95 ^a	190 ^a	116	305	1100	1400	7200	36000	122
Principal Export(A)	30	36	45	45	173	379	2237	2237	78
Mid Import (B)	57	68	72	72	270	540	1612	1612	105
Average Tax Rates %									
Exports (C)	2	3	6	14	4	1	-	-	-
Imports (D)	27	34	7	9	3	4	4	5	2
Exchange Rates									
Adjusted for Tax									
Exports(E)=(A)x $\frac{100-(C)}{100}$	29	35	42	39	166	375	2237	2237	78
Imports(F)=(B)x $\frac{100+(D)}{100}$	72	91	77	78	278	562	1676	1693	107
Net Legal Barter									
Returns									
Cents per dollar									
of Exports									
(E)÷(F) x100	40	38	55	50	60	67	(133) ^b	(132) ^b	73

a. End of Year

b. Lower range of rate for luxury imports was Rp 3,612 which was equivalent to tax adjusted rates of Rp 3,756 in 1964 and Rp 3,793 in 1965 hence net barter rates of return were 60 cents and 59 cents respectively.

The barter returns to blackmarket transactions were always of course 100 cents per dollar.

Source: Simkins BIES

Indonesia's Exports and Imports 1958-67.*

(US\$ mn.)	<u>Recorded Exports</u>	<u>Estimated Unrecorded Exports</u>	<u>Recorded Imports</u>	<u>Estimated Unrecorded Imports</u>
1958	791	240	544	135
1959	931	155	483	113
1960	841	233	574	197
1961	788	145	794	216
1962	682	210	647	168
Average	807	197	608	166

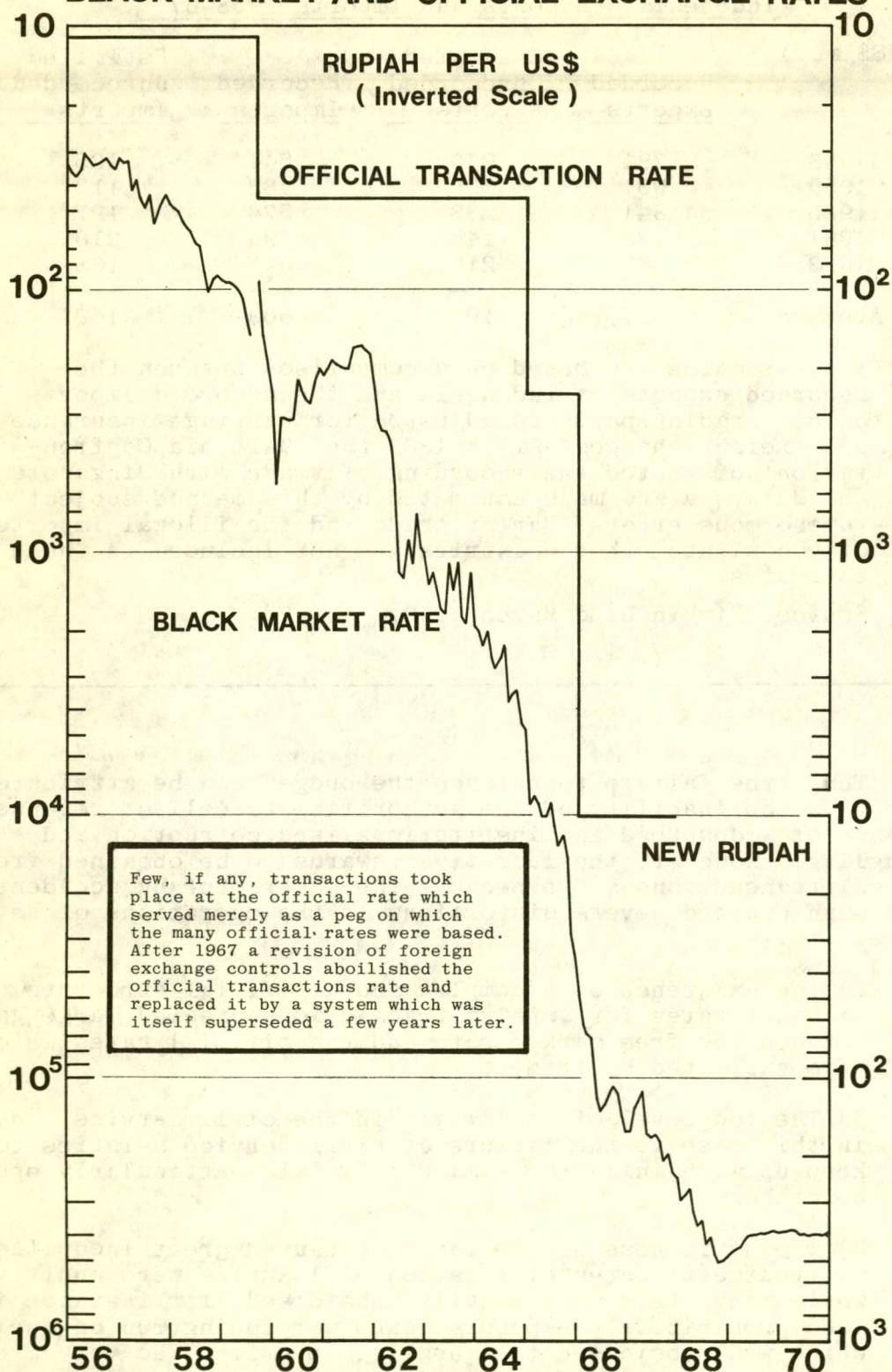
* The estimates are based on a comparison between the recorded exports of Indonesia and the recorded imports of her trading partners adjusted for carriage insurance and freight charges. After 1962 the 'Malaysia Confrontation' disrupted the recording of trade with Singapore and Malaysia and made estimates by this method subject to enormous errors. Barter trade and the illegal imports of goods into other countries are not included in these estimates.

Source: Simkin BIES March 1970.

Thus, the failure to balance the budget can be attributed mainly to the inability of the authorities to collect revenue because of widespread and institutionalised corruption and smuggling. However, the lucrative rewards to be obtained from illegal transactions arose because the government by accident or design created severe distortions in the operations of several markets.

- 1) The existence of a complex and artificial structure of exchange rates for foreign transactions created large gaps between the free market rate and the official rates which were exploited by traders.
- 2) The low level of real wages in the civil service - due in this case to the failure of civil service salaries to keep up with inflation - made officials particularly open to bribery.
- 3) The narrowness of the tax base caused great inequities of treatment: rates of taxation of luxuries were punitive while many items were heavily subsidised, for instance in 1965 prohibitively expensive cars were being run on fuel which was subsidised to a negligible price. The very great differences between the taxed and untaxed prices of articles provided many opportunities for profitable black market trade.

INDONESIA BLACK MARKET AND OFFICIAL EXCHANGE RATES



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The distortion created by government intervention in markets was worsened by high rates of inflation because most of the taxes and official prices were fixed in nominal values which were slow to be adjusted to the rising general price level. Inflation, by undermining the real value of nominal tax revenues and increasing the incentives to illegal trade, widened the budget deficit and thus increased the inflationary pressures. The process was therefore a vicious circle: inflation increased the deficit which stimulated further inflation. Periods of high inflation in all countries test the flexibility and resourcefulness of the government administration; what was so remarkable in Indonesia was that even moderate rates of inflation proved too much for the authorities. Little they could do could halt the ruinous effects of inflation on revenue and expenditure which caused the deficit to widen. But a budget deficit need not necessarily be inflationary. The effect of a budget deficit on the economy depends critically on how it is financed.

Financing the Deficit

There are just three ways a government can finance its expenditure. The first is taxation, the second is borrowing and the third is printing money. Having failed to obtain sufficient finance through taxation the government was obliged to fall back on the second and third methods to fund the resulting deficit. In practice the second method had only very limited potential in Indonesia. Because of the undeveloped nature of the country and the lack of financial intermediaries there was no possibility that the deficits could be fully financed by borrowing via bond sales either to the banks or to the general public.

The public's holdings of financial assets were exceptionally low compared with most other countries: for instance bank deposits were equal to only 4.3% of GDP in 1958 and only 2.3% in 1962, compared with 19% in Malaysia and 54% in Japan at that time. Thus, to finance even a moderate budget deficit by domestic borrowing was beyond the capabilities of the financial system.

Whereas in Malaysia a budget deficit of 3% of GNP could be financed domestically without inflation in the early 60s it is unlikely that a deficit of that size could have been financed in Indonesia without coercion even assuming strenuous and efficient efforts by the authorities. Inevitably, therefore, as the deficits widened in the late fifties the government could only fall back on the third method of financing - the printing presses, with appalling consequences for monetary expansion and inflation.

There were however two major attempts to stem the flood of money. The first in 1950 attempted to reduce the inflationary effect of the monetary expansion which had occurred during the revolutionary war. In March 1950 all currency was devalued to 50% of face value except for notes and coins of denominations of 2½ rupiah and smaller. In addition, 50% of bank deposits over Rp.1,400, were taken by the government as a compulsory contribution which was exchanged for bonds paying 3% to be redeemed in installments over the following forty years. The demonetization of the currency was in effect a tax, because it took

purchasing power away from the people, while the confiscation of bank deposits was a compulsory loan because it exchanged current claims on goods and services for claims on goods and services in the future. In fact, as it turned out, the compulsory loans were almost pure taxes because subsequent inflation so eroded the value of the bonds issued that they were virtually worthless on redemption. In 1965 the Rp. 916 million still outstanding of this loan had lost 99½% of its real value since 1950.

The Sukarno Axe

The second monetary reform occurred in 1959. It too consisted mainly of the confiscation of bank deposits and demonetization of the currency but it was far more drastic than the 1950 reforms and brought the country to a virtual standstill. In many ways the reform was a watershed for it marked the end of the indecisive governments and rebellions of the 1950s, and the beginning of the 'Guided Economy' when government intervention in the economy became almost Draconian in conception and disastrous in implementation.

The reform came after over 18 months of political and economic turmoil. At the beginning of 1958 the political scene was rapidly becoming unstable, the communist dominated unions seized the assets of the Koninklijke Paketvaart Maatschappij (KPM), the Dutch inter-island shipping line and of the NHM (Nederlandsche Handel-Maatschappij), a major Dutch trading company, and other Dutch companies were taken over. The result was severe disruption of inter-island trade and communications and dislocation of many of the major exporting enterprises.

Over the next few years all Dutch assets were seized and there was an exodus of Dutch expatriates. Desperate attempts to get capital out of the country sent the blackmarket Rupiah rate plummeting. (A popular method of getting capital out of the country was to under-invoice imports and over-state the value of exports and this probably constituted a major portion of Indonesia's unrecorded trade.)

The Dutch exodus came at the same time as the Sumatran rebellion. A group of pragmatic moderates in alliance with local military forces attempted to force a reform of the cabinet. When the government failed to respond to their demands a revolutionary government was declared in Padang in West Sumatra. Although the rebellion was squashed and no reform was carried out, the rebellion had an effect the rebel leaders had not intended. Far from restoring authoritative government, the rebellion only served to strengthen the power of the army which gained enormous influence and prestige by its success over the rebel forces.

Economically the turmoil of 1958 was disastrous. Production and trade were dislocated and real GNP was estimated to have fallen by at least 10%. The increased military expenditure and the disruption caused the budget deficit to double in size compared with 1957. The money supply grew 55% in 1958 compared with 42% in the previous year and this burgeoning money supply in combination with falling output led to a rapid acceleration in inflation. Consumer prices in Jakarta rose at a rate of over

40% per annum in the first half of 1958. The free market rupiah summed up the situation in a sharp fall of 50% against the US dollar

As the economy staggered into 1959, Sukarno seized absolute power, announced the commencement of 'Guided Democracy' and began to lay out plans for his 'Guided Economy'. The first major action of the new regime was to 'reform' the currency though the reforms were probably largely the work of Djuanda, the Prime Minister, as Sukarno himself was notoriously indifferent to and ignorant of economic matters.

Ill thought out and hastily produced, the new measures caused chaos and crippled production but totally failed to arrest monetary expansion or inflation.

The principal measures announced on August 25th 1959 were the following:

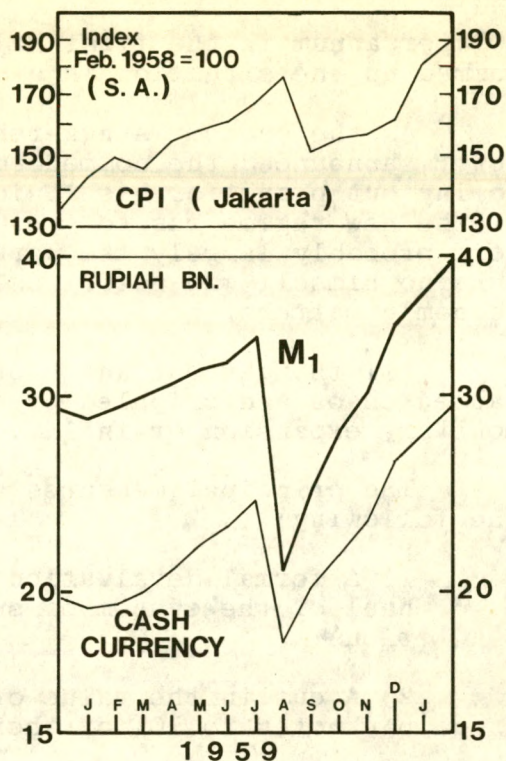
- 1) A formal devaluation of the Rupiah and a thorough overhaul of the system of surcharges, tariffs and trade restrictions.
- 2) A cut in the value of circulating Rp 500 and Rp 1,000 banknotes to 10% of their face value.
- 3) Confiscation of 90% of every bank deposit in excess of 25,000 Rp. to be converted into a long term loan to the government.
- 4) A cut in civil servants salaries above Rp 2,000 per month and a suggestion "to private enterprises to adjust themselves to the new regulation."

Sukarno and Djuanda produced these measures apparently without consulting either the Governor of Bank Indonesia or the Ministers of the Inner Cabinet. The announcement of the measures caused considerable confusion and, in the ensuing chaos, over thirty amendments and clarifications were announced.

The confiscation of individuals' bank deposits was bad enough but the blocking of company accounts was disastrous. Suddenly companies found themselves without cash to pay wages, settle debts or make any other day-to-day transactions. Though exemption from deposit confiscation could be granted at the discretion of the authorities the most notable beneficiaries were state enterprises; the private companies could only hope for exemption by currying favour with officials. Normal commerce ground to a halt.

The enormity of what they had done quickly dawned on the authorities and four days after the initial announcement it was announced that Bank Indonesia would provide emergency credit to banks so that they could ease companies through the period of adjustment. But by providing the additional credit the government effectively undid the beneficial monetary contraction caused by the reforms. True, there were credit ceilings (first intro-

duced in 1957) but they had proved completely ineffective even before the 'Sukarno Axe'. New credit ceilings had been set just three weeks earlier - on August 3rd - but they had been doomed from the beginning because state enterprises had demanded credit in order to finance 'essential' imports and purchase domestic rice. The exemption of State enterprises thus made the credit ceilings meaningless even before the demand for emergency credit washed them away completely. By the end of the year the banks had extended Rp 11,432.1 million worth of credits compared with a 'ceiling' of Rp 6,694.8 million. Even subtracting the amount of credit given to companies officially exempted the amount of credit for which the ceiling was still applicable totalled Rp 8,263.4 million.



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		Commercial Banks	
		Total Credit	
	<u>Date</u>	<u>in Million Rupiah</u>	<u>Change</u>
1959:	March	6,448.4	
	June	6,377.6	-70.7
	July	6,326.0	-51.7
	September	6,843.4	+517.4
	December	11,432.1	+4,588.7

Source: Bank Indonesia Annual Report.

The result of the explosion in bank credit was a rocketing money supply. Overall the monetary measures had caused a once-for-all cut in the value of currency in circulation of 30% and a cut in the value of deposits of 70% causing a drop in M₁ of 38%, yet by the end of the year the money supply had regained all lost ground and was back on the trend line.

Not surprisingly the critical shortage of cash-in-hand led to a sharp fall in consumer demand and at the same time traders also short of money dumped stocks on the market to raise cash. The combination of a fall in demand and an increase in the supply caused a drop in prices: the Jakarta cost of living index fell by 8% in one month.

Immediately after the currency reform there were a few incidences of unofficial currencies being pressed into service in rural areas. The severe shortage of cash meant that rubber millers were unable to pay for the rubber slabs they bought from small-holders. So the small-holders, also in desperate straits, accepted IOU's albeit at heavily discounted prices and for a short time these IOUs were accepted in exchange for food and vegetables by traders.

The trade controls introduced at the same time as the currency 'reforms' had an opposite effect on prices; by postponing and rejecting most import applications by private traders in an attempt to bring all trade under the control of public enterprise the authorities caused the supply of imported goods to be sharply constricted. Thus after the markets had cleared the initial surplus of stocks dumped as a result of the reforms the shortage of imported goods contributed to the recommencement of price inflation.

The demonetization of the banknotes and the confiscation of deposits did nothing to halt the trend of inflation because it was merely a once for all cut in the money supply, while the root causes of the monetary expansion were left unassailed. The foreign exchange reforms and the cut in civil service salaries could have contributed to balancing the budget and reducing the need to create money, but the measures taken were inadequate. The cut in civil service salaries insofar as it was implemented probably made the bureaucracy more open to persuasion by bribery and tempted by opportunities for graft. The foreign exchange reforms were more a catching-up operation to restore the effective exchange rates to levels more compatible with the domestic price level. To the extent to which they attempted to extract more tax from trade the measures further increased the returns to smuggling. The reforms made no attempt to simplify the foreign exchange controls.

Perhaps an indication of the failure of the 1959 reforms is the fact that new controls on bank credit had to be established early in 1960 and a further overhaul of the foreign trade system was also required in that year.

The reasons for the 1959 'reforms' are unclear. Officially the demonetization of the currency was "considered necessary to reduce the amount of money in circulation for purposes of improving the financial and economic situation of the State." Unofficially an ulterior motive was suspected. It has been suggested that the reforms were cunningly designed to force all banks and private enterprise into the clutches of the state, as part of the overall plan to create a 'Guided Economy'. By first of all depriving all private companies of their money and then handing it back in the form of credits, the government forced many private banks and companies into dependence on the state. The Far Eastern Economic Review reported: "These credits can be given in such a way that the Government gets control of the enterprises concerned. If a certain business is not worthwhile or not in "good" hands according to the officials concerned, what will be easier than to refuse a credit, which means that the business has to close down. There

is a huge struggle for credits going on in Indonesia. It is a struggle for life and people concerned are trying their utmost to get the favour of officials who can do something in the field of credits."

Trade increasingly went through the Big Eight state trading companies and banks were forbidden to give credit to private importers many of whom as a result were forced out of business. Whether or not the reforms were part of a calculated strategy to obtain state control of commerce they certainly had that effect.

The monetary reforms were also supposed to hit at 'speculators' and smugglers. The government said that these illegal traders kept their earnings in cash to avoid the government surveillance of bank deposits, so by demonetizing the large denomination notes the government aimed to seize their ill-gotten gains. As the Far Eastern Economic Review wryly pointed out this apparently meant that the government believed 44% of the money stock was 'hot' money. Yet, when the Rp 500 notes were demonetized they were only worth approximately US\$5 on the black-market certainly not too large a denomination to be held by the man in the street. Demonetization was a very clumsy method of hitting at illegal traders for undoubtedly the small man as well as the illegal trader was hit by the monetary measures.

In the light of what was to follow the monetary reforms of 1959 paled into insignificance. When they were introduced the rate of growth in the money supply and the rate of inflation were comparatively moderate and the budget deficit was comparatively small but 'the Sukarno axe' was important in that it presaged the deterioration in economic and political policy in the years of the Guided Democracy. Henceforth the government was to be not only negligent and incompetent but also malevolent in its treatment of private companies and free enterprise.

(To be continued)

BOOK REVIEW

"CONTEMPORARY JAPANESE BUDGET POLITICS" by John Creighton Campbell
for the East Asian Institute of Columbia University.
(University of California Press, Berkeley, 1977.)

One of the salient features of Japan's economy in the three decades since 1949 has been stability of government expenditure as a share of Gross National Expenditure. Both government consumption expenditure and government fixed capital formation each remained consistently below 10 percent of GNE until 1975, and since then the latter has crept up to just 11 percent. Against the background of an intellectual environment in the universities which has been dominated by Marxist economic theory on one side and modern (i.e. Keynesian) economists on the other, it is surprising at first glance that the budgeting process has been characterised by a consistently conservative stance on public sector expenditures. How is it that there is such a striking contrast between the limited role of government expenditures in Japan and the steadily growing role of such activity in recent years in the economies of Western Europe and North America?

The simple answer is that Japanese politics have been dominated by a single party, the Liberal Democratic Party since the early 1950s, and that ideologically LDP politicians have preferred a larger private sector to any significant expansion in the role of government. It is also true that due to the particular method of LDP financing and distortions in the equality of representation among the constituencies, there has been a bias towards favouring special interest groups in the industrial or agricultural sectors rather than favouring any minorities such as the poor, the burakumin, or the minority Korean population.

The deeper answer given by John Creighton Campbell in "Contemporary Japanese Budget Politics" requires a close study of the role of the Ministry of Finance in the whole parliamentary and bureaucratic process of budgeting. The book provides a detailed analytical examination of the budgeting system - the role of the Prime Minister, the Cabinet, the Ministries, and the politicians - together with a chronological sketch of Japanese budgets in the years 1954-74 illustrating the analytical observations with case histories, written from the standpoint of a political scientist.

Being a central activity common to all governments and therefore capable of international comparisons, the budgeting process is an ideal subject for such analysis. From the economic standpoint, too, the process by which 20 percent of the resources of the free world's second largest economy are allocated to one use or another merits study. For, separate from the stability of total Japanese government expenditure as a share of GNE, the components of government expenditure have also remained comparatively steady throughout the post-occupation years. In his book Creighton Campbell sets out a comparative table of changes in major components of expenditure in the United States and Japan over a ten year period. The crucial reason, he observes, for the less stable appearance of the American budget is that a few large programs saw their expenditures doubled (the space program), almost tripled (education), or even sextupled (health), in terms of shares. These changes came from outside as explicit presidential decisions: Kennedy's to reach the moon, and Johnson's to declare war on poverty.

In the Japanese case neither the legislature, the Cabinet, the bureaucratic elite, nor organised big business have been able to play such a role, so that if new policies were to be imposed externally on the budgetary process they would have to come from the Prime Minister or the LDP. But the LDP, according to the author, has been preoccupied with micro-budgeting rather than making and carrying out comprehensive policy

changes, and the Prime Minister, with a few exceptions, has confined his role to the achievement of harmony or consensus rather than the formulation and implementation of major domestic initiatives. Thus no one has intervened in the budgetary decisions; the routine structural and procedural elements of the Japanese budgeting system with their tendency towards inertia have dominated, ensuring unusually stable outputs. In short, procedures and the guiding hand of the Ministry of Finance bureaucrats have determined most budgetary behaviour.

In the allocation of expenditures the budget has been dominated by the principle of gradualism or incrementalism - expenditures here are shaved while expenditures there are increased marginally. On the financing side the combination of high rates of economic growth and rigorous examination of spending proposals followed by tight controls on the authorisation of expenditure - closely monitored by one of the world's most elite cadres of bureaucrats - produced budget surpluses (and tax cuts) year after year until 1965. In that year the monetary squeeze of 1964 produced a sudden drop in tax revenue and necessitated a major programme of deficit financing for the first time since the imposition of the "Dodge Line". The economic crisis of 1973-74 also reduced tax revenues sharply, requiring extended deficit financing. It is no coincidence that in both cases subsequent monetary policy was deliberately restrained rather than exuberantly expansionary, and the relatively slow recovery in the economy on each occasion meant that tax revenue from corporate profits and personal incomes failed to rise rapidly enough to finance the deficit from tax revenues. Despite the voluminous rhetoric to the contrary, in neither case has a sustained deficit been associated with higher inflation. On the contrary, inflation has decelerated on each occasion.

Creighton Campbell makes no pretense at any economic analysis of the relationship or lack of relationship between the budget deficits and inflation, but the nature of the link between monetary and fiscal policy is surely a crucial issue. The evidence on the subject points firmly towards the conclusion that in Japan's business cycle monetary policy has almost invariably tended to dominate fiscal policy. Inevitably, therefore, Japanese budget politics have tended to be preoccupied with the lesser questions of how the cake shall be divided up, rather than with the question of how the size of the economic cake may fluctuate and what - if anything - fine tuning can do to minimise those fluctuations. The fact that Creighton Campbell does not deal with these wider issues is not meant as any criticism. The value of the book for the student of the Japanese economy lies in its comprehensive treatment of the narrower range of budget issues, and in the challenge it poses to economists to examine and explain the wider issues which underlie the extraordinarily successful interaction of politicians, bureaucrats and businessmen in the Japanese budgetary process.

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Indonesia under Sukarno: To the Abyss and Back.
(Part 2)

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

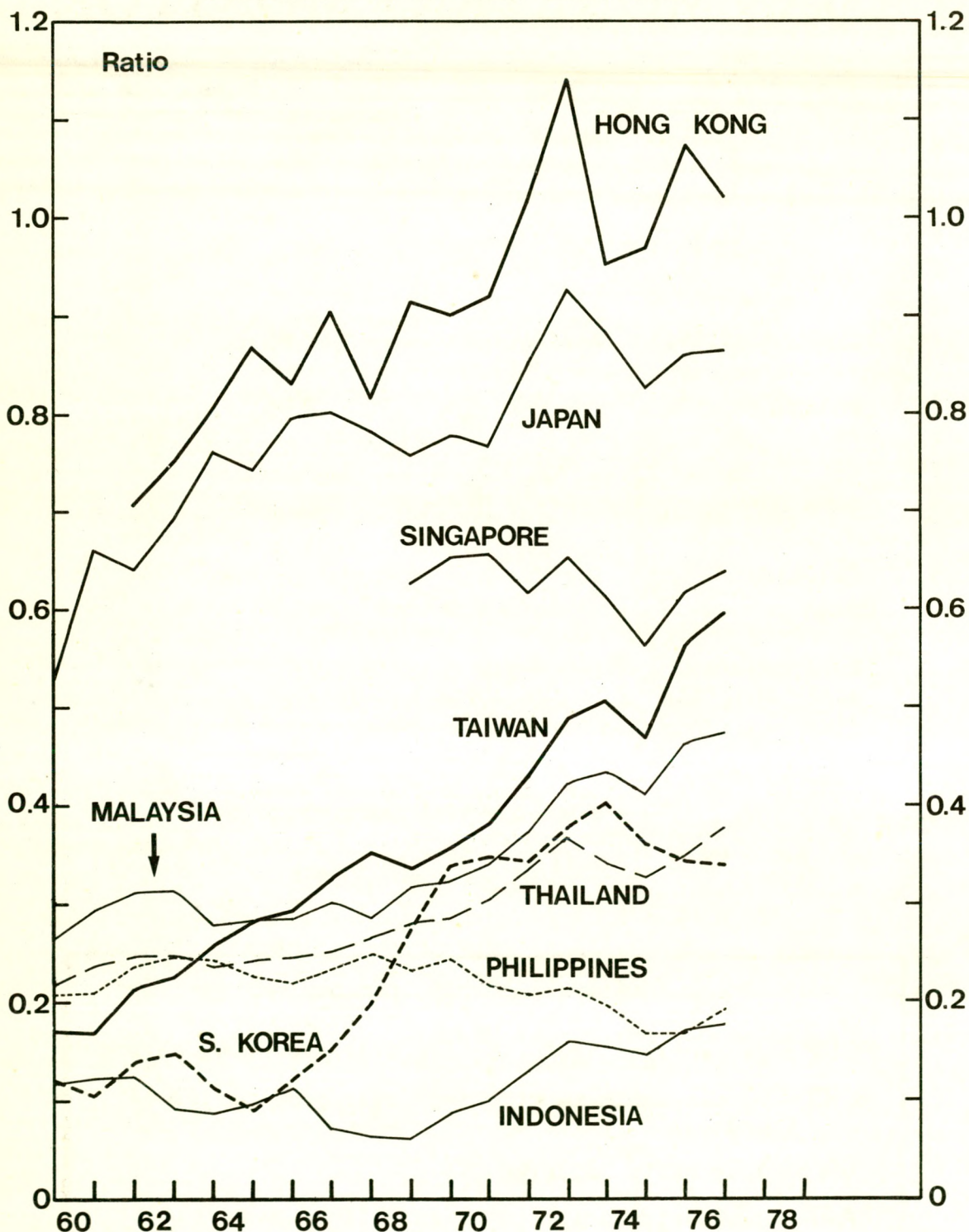
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

CHART 1

MARSHALL k IN THE FAR EAST



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REGIONAL SURVEY

MARSHALL k IN THE FAR EAST

Marshall k is defined as the ratio of money to money income. Its significance has been widely debated by economists for many years, and it is the crux on which monetary policy depends. If it can be shown that Marshall k is largely a predictable function of a few economic variables, then by controlling the money supply the authorities can influence money income.

In algebraic form:

$$M = kY$$

where 'M' is money supply, 'k' is Marshall k and Y is money income. If M is controlled and k is predetermined then Y can be affected by variations in M. In other words Marshall k is the lever through which monetary policy acts on nominal income. If the lever is weak or the pivot loose then monetary policy will have a feeble or erratic effect on incomes. Understanding the behaviour of Marshall k is therefore of vital importance for the understanding of the effects of monetary policy.

Examination of Marshall k for countries in the Far East reveals some of the principles involved. To begin with however, it is worth pointing out that the definition of Marshall k used here* is employed only for consistency and convenience and that for every country a more carefully chosen definition may better illustrate the fundamental principles involved.

Firstly, it is clear that for nearly all the countries considered, k has risen since 1960, that is, money holdings are equal to a higher proportion of annual income in 1978 than they were in 1960. This phenomenon has been observed in many countries at various times in their history; the most famous empirical observation of it was by Friedman and Schwartz for the USA from 1867 to World War II. It is generally held that the rise in Marshall k arises from the increasing propensity to hold money as real income rises. If this is the case, then Marshall k would be expected to rise fastest in countries where real GNP has been growing most rapidly. Certainly at one extreme Korea and Taiwan have experienced high growth rates and rapid increases in Marshall k, and at the other Indonesia had relatively low rates of growth and a stagnating Marshall k until the 1970s.

International comparisons of real per capita GNP also support this argument (see Chart 2). Those countries with low levels of per-capita income have lower values of Marshall k - most notably Indonesia and the Philippines - while more prosperous nations (e.g. Taiwan and Malaysia) have rather higher values.

* Marshallian $k = \frac{M}{Y}$ where $M = M_1 + \text{quasi money}$, - - - - -

and GNP = Gross National Product; both variables as defined by the IMF.

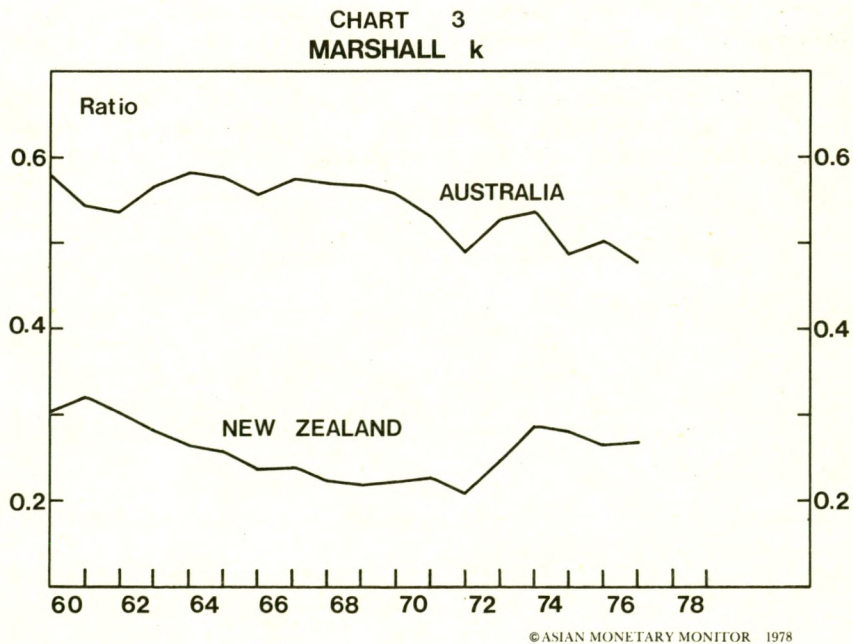
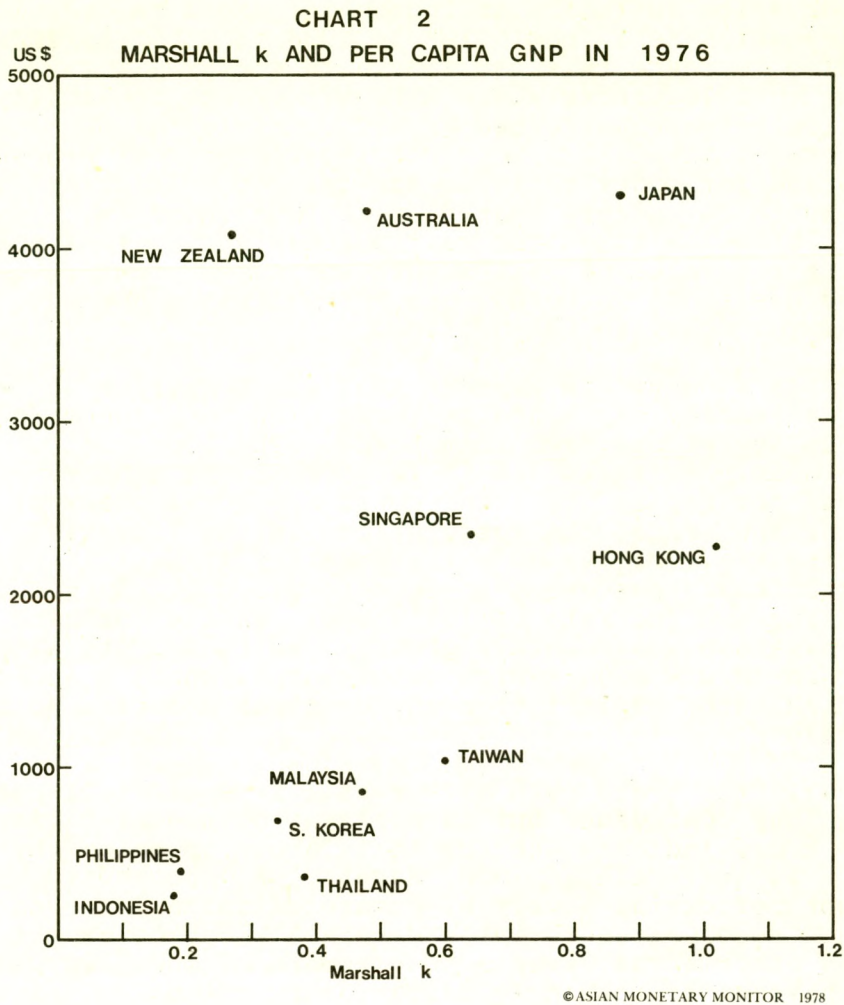
The reasons for this are manifold. It is likely that as people become better off they prefer to hold proportionately more money compared with their income possibly as added security to cope with unforeseen expenditures. Also, as a country develops the importance of barter transactions declines and manufacturing and service sectors grow relative to agriculture, so that people are employed in activities requiring more money transactions than in the past.

Australia and New Zealand do not fit into this pattern. Despite high levels of per capita income, they have values of Marshall k smaller than Taiwan, and in both countries Marshall k has declined since 1960. This may reflect the fact that they are both Western countries which have not undergone the large structural changes experienced by the oriental developing countries. It may also indicate that the IMF definition of money excludes substantial financial assets which are money substitutes for their holders. In Australia in particular non-bank financial institutions such as Finance Companies, Building Societies and Life Insurance Companies play an important role in the financial system. In December 1977 total assets of Finance Companies exceeded the total value of M_1 by almost A\$2 billion.

It may also be that beyond a certain level of per capita income the demand for money grows less than proportionately with income. If this is the case then Marshall k in Japan could be expected to grow more slowly than in the past or even decline. Inevitably the institutional and economic structure of a country have an important effect on the costs and benefits of holding money, which make international comparisons difficult.

Super-imposed on the long run trends in Marshall k are cyclical variations which show a consistent pattern. Hong Kong, Japan, Singapore, Thailand, the Philippines and Indonesia all have peaks in Marshall k in 1972; Australia, Malaysia, Korea and New Zealand peak in 1973, while all the countries examined show troughs in 1974. Similar fluctuations are observed in European countries. To a large extent this synchronization of movement can be attributed to the transmission of the effects of monetary policy from one country to another. A number of countries followed highly expansionary monetary policies in 1972, most notably the USA, Britain and Japan. This manifested itself in increases in the foreign reserves of other countries, which then experienced their own monetary expansions by multiple deposit creation on their expanded reserve bases. Thus, the ratio of money to GNP was temporarily shifted above the trend line in most economies of the Far East. The only way that Marshall k could return to its trend level was by a rise in GNP, which duly took place, but this was achieved mainly by increases in prices rather than increases in output.

What is the effect of inflation on Marshall k? From the experiences of Korea in 1963 and 1964 and of Indonesia in the midsixties it is clear that Marshall k falls when inflation is high. In 1964 Korea experienced consumer price increases of over 40% p.a. and k fell to 0.091 from 0.148 in 1962.



In 1962 price inflation in Indonesia jumped to over 100% p.a. and Marshall k fell from 0.123 in 1960 to 0.093 in 1962. These examples indicate that the trough in Marshall k throughout the Far East in 1974 probably was a result of the abnormally high inflation rates experienced in all countries at that time. This behaviour of Marshall k supports the theoretical proposition that the demand for money falls as the cost of holding it increases, which is exactly what happens when there is inflation. Inflation taxes the real purchasing power of money while leaving the value of real assets unchanged, thus it becomes more desirable to hold goods rather than money and the desired ratio of money to GNP declines.

CONCLUSION: In summary, it appears that the behaviour of Marshall k is readily explained in terms of a long run trend and short run deviations from that trend. The long run behaviour probably reflects 'real' factors in the economy, for instance real per capita GNP, the growth and development of manufacturing and trade, the institutions in the financial system and the availability of extra-monetary financial assets. The short-term behaviour seems to be determined by changes in monetary policy and the rate of inflation. On the one hand a relatively expansionary monetary growth - as took place almost universally in 1972 - causes high values of Marshall k and on the other, high rates of inflation and/or tight monetary policy cause low values.

Naturally the trend path of Marshall k is difficult to predict with any confidence but an analysis of recent variations in Marshall k may indicate whether it is above or below the trend line. In Australia in 1976, Marshall k appeared to be rather low, no doubt reflecting a very high rate of inflation, but as inflation has decelerated recently Marshall k can be expected to rise. In other words, even a stable rate of money supply growth may have an increasingly deflationary effect on prices. In Japan also the same phenomenon has been observed: stable monetary growth in 1977 has been followed by rapidly decelerating prices. Conversely in Thailand, the Philippines, and Taiwan, Marshall k was rather high in 1976 indicating that unless monetary policy is deliberately very expansionary in the near future Marshall k will return to trend through a rapid growth in nominal GNP, and steady or accelerating inflation can be expected.

AUSTRALIA

THE MONETARY BASE AND PROBLEMS OF MONETARY CONTROL

Compared with the decade of the 1960s the period since 1970 in Australia has been characterised by peculiarly unstable monetary growth, with wide fluctuations of M_3 ranging from almost 30% to less than 5%. Over the same period the economy itself has been subject to correspondingly wide cyclical swings. A variety of theories could be offered at several different levels to explain this phenomenon. At the political level it could be said that a long swing of the pendulum to the right was followed by a sharp jolt to the left, which was in turn reversed by an equally sharp move back to the right, and that these swings were naturally disruptive for the economy. At another level it could be argued that fluctuations in Australia's economic fortunes have been largely determined by external factors, starting with the great boom of 1971-73 which generated a worldwide inflation from which Australia could hardly escape, and that this was succeeded by a major recession accompanied by rising protectionism in Japan, Europe and the U.S.A. that has so far frustrated the recovery of the mining and agricultural sectors of the Australian economy. Since these are the leading export earners in an economy where much of the GDP is derived from the primary sector, it is argued that conditions overseas must improve before the Australian economy can hope to recover from its recessionary condition. While such explanations have the immediate attraction of simplicity, they lack first the ability to pinpoint correctly the timing or the magnitude of changes in the Australian economy, and second they fail to explain the divergences which have emerged between the performance of the Australian economy and other major economies of the world.

The explanation which follows considers a different line of analysis. Accompanying charts show that fluctuations in monetary growth have been the primary cause of fluctuations in the Australian economy. At a deeper level, monetary analysis shows that the variation in monetary growth rates is in turn due largely to the pattern of movements of the monetary base, which themselves originate (1) from the authorities' policy of effectively pegging the exchange rate and (2) from the impact of the government budget on the banking system. The predictions which flow from the analysis contain both favourable and unfavourable elements. The policy recommendations deriving naturally from the analysis suggest that to restore a measure of longer term economic stability to the Australian economy as opposed to a temporary cyclical improvement the authorities should (1) revise their exchange rate policy (2) reconsider the present structure of reserve ratios in the banking system in the light of the need to regulate the growth of the monetary base.

The relationships between fluctuations in key measures of money, output and prices are set out graphically in Chart 1. Some of those relationships and their implications for the

future were spelled out in AMM Vol. 1 No. 2 (p.5); in the present analysis the point to be emphasised is the consistency of these relationships: despite the different sources and different methods of compilation of statistics of money, the index of manufacturing production, nominal and real GDP, and the consumer price index, they all show a remarkably faithful adherence to the pattern traced out by changes in the quantity of money. The persistence of such patterns over long periods of time through different political regimes in any single economy, and the existence of such patterns in economies of widely differing states of development or resource-endowment implies that these relationships are fundamental to the understanding of economic fluctuations in all economies at all times. In Australia over the period 1960-78 shown in Chart 1 the average lag between peaks in M_3 and peaks in the index of manufacturing production is nine months, and 11.4 months for real GDP; for cyclical troughs the length of the lag is slightly shorter - eight months for manufacturing production and 8.75 months for real GDP. The lag in effect between money and prices is much longer, with the peak in consumer price inflation occurring somewhere between 16 and 30 months after the peak in monetary growth depending on the point chosen as the cyclical peak, and the trough in inflation coming 22 months after the trough in monetary growth.

The Monetary Base as the Determinant of Fluctuations in Money Supply

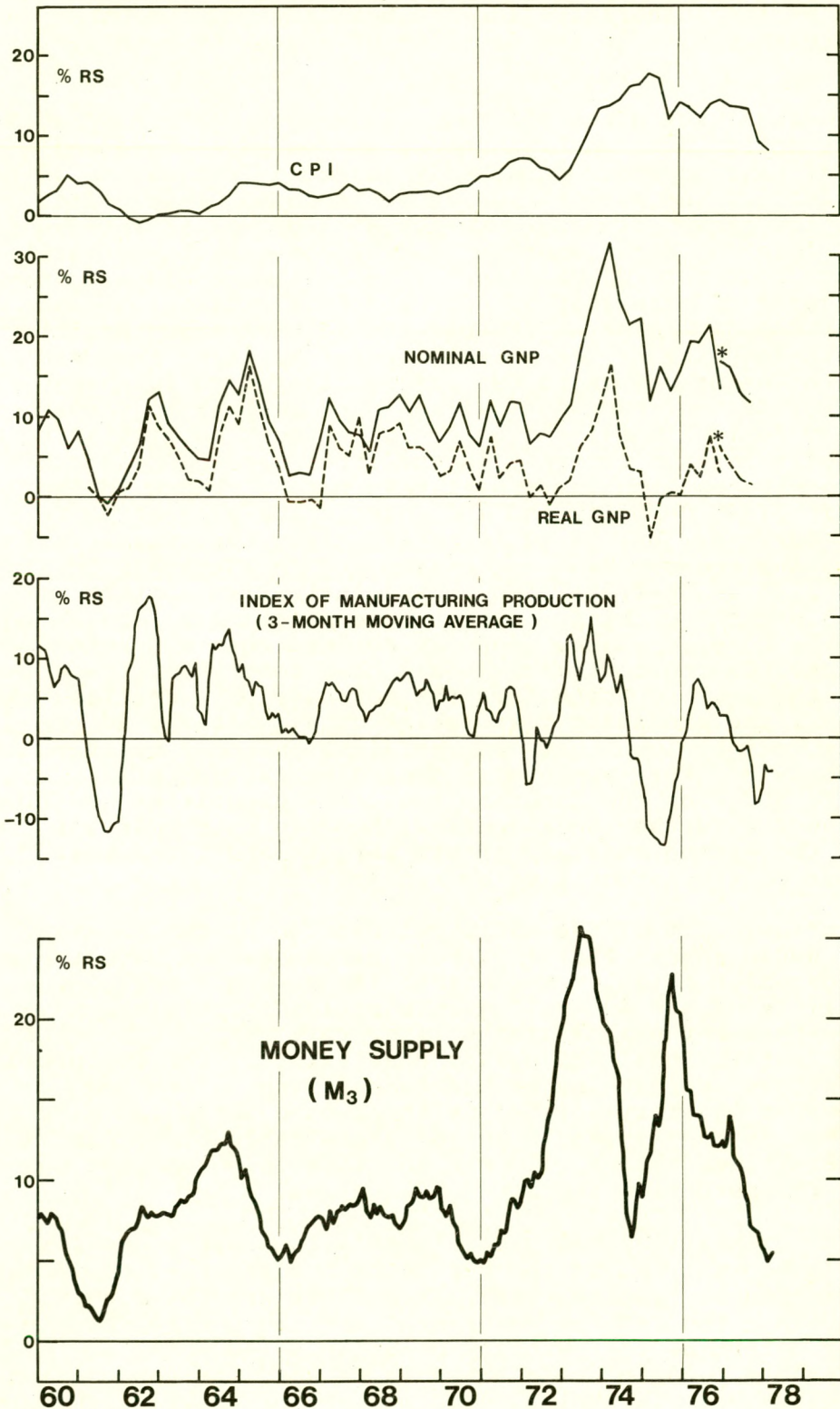
The Australian authorities have recognised the importance of the relationship between money and other economic magnitudes by moving to announce targets for monetary growth on a more or less regular basis. Starting in March 1976 the then Treasurer Phillip Lynch announced that growth of M_3 was targeted to remain in the 11-13% range for the year to June 30, 1976, considerably below the 20.4% in the year to December 1975. Subsequent monetary targets have been gradually reduced so that current intentions are 8-10 percent growth for M_3 in the year to June 1978. Initially the authorities appeared to be quite successful in achieving their targets, but more recently they have tended to undershoot. Growth of M_3 in the year to February 1978 was 5.0%, while deposit growth of the Major Trading Banks had declined to -0.9% in the same period. Since the currency component of M_3 was the only item to show any growth in excess of the minimum 3% target and since cash currency held by the public is a lagging component of the money supply, some further deceleration is still possible. Why have the authorities been undershooting? Was their earlier success fortuitous?

One explanation is that "money supply is running well below target.... because about 25 per cent of domestically generated money supply growth is spilling out of the country leaving inadequate internal supply."* This view also maintains that, "Right now our monetary Authorities are busy expanding the internal money base The Government can easily enough expand gross domestic money supply. But so long as the private sector spills its credit across the exchanges.... the expansion of domestic money will not result in a commensurate growth in

* SYNTEC, No. 67, April 7, 1978.

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



*Change of data series.

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net money supply available to the economy." Such views and recommendations based on them are highly suspect. The problem is that such analysis obscures the true relation between the actions of the Authorities and the behaviour of the banks and the non-bank public in the creation of any given quantity of money.

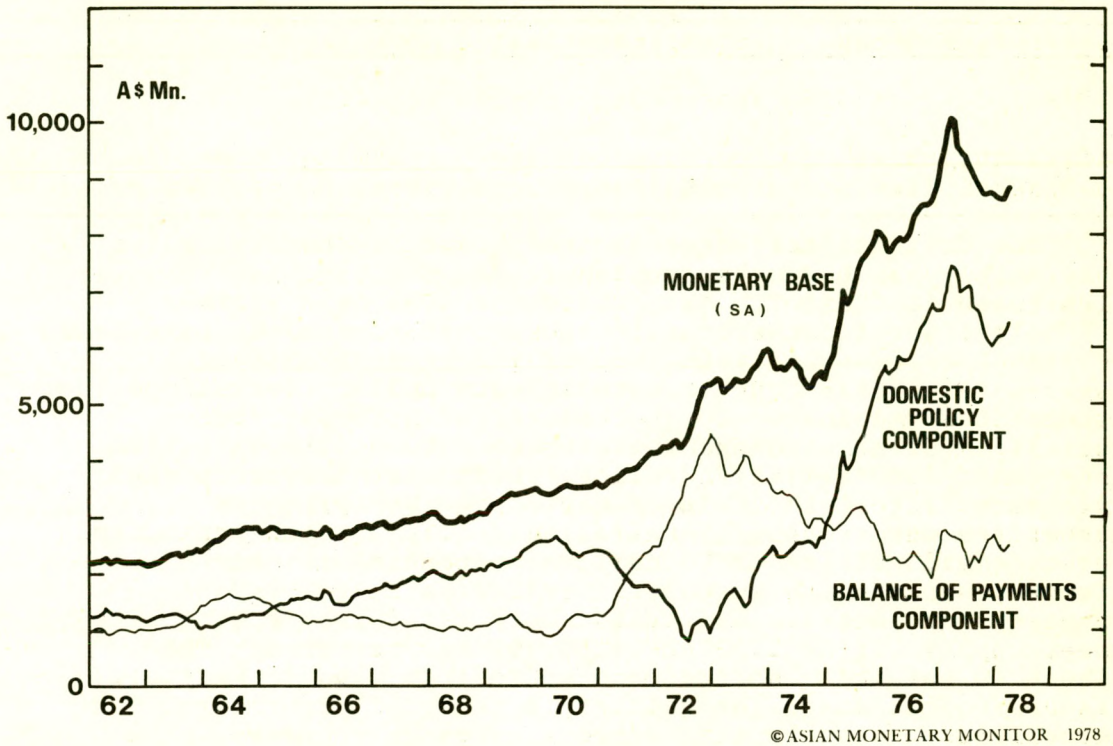
In the first place all money is domestically generated: the distinction between bank deposits created at home and a net supply of bank deposits supposedly injected from abroad is untenable. If the authorities chose to do so, they could control the growth of aggregate deposits by regulating the overall level of bank reserves via the monetary base, but in the absence of foreign exchange controls they could not prevent the transfer of ownership of deposits from resident to non-resident deposit-holders. Second, to talk of money spilling out of the country or the private sector spilling its credit across the exchanges is to use purely figurative language. To obtain foreign currency Australians must sell A\$ to foreigners (or other Australians), while foreigners must be willing to buy A\$ and sell foreign currency in the foreign exchange market. After the transaction there will have been a change in the ownership of A\$ deposits and a change in the ownership of foreign currency, but there is no effect on the quantity of A\$ - unless the Reserve Bank intervenes and deliberately creates (i.e. sells) or destroys (i.e. buys) Australian dollars in order to peg the exchange rate at some particular level. Third, the monetary base, properly defined, has not been expanding. On the contrary, it has been contracting (see Chart 2). In the year to March 1978 the monetary base declined by 11.7% over the preceding year, while on a quarterly average basis it fell by 10.3% between the first calendar quarters of 1977 and 1978. Far from busily expanding the quantity of money, to judge by the monetary base the Authorities are likely to engineer a further deceleration. How can this contradiction between the stated monetary growth targets and the actual behaviour of the Authorities be reconciled?

In the light of the sharp contraction of the monetary base it would appear that fortunate circumstances have for a while concealed a faulty mechanism. As we shall argue, the real ability of the Australian authorities to regulate monetary growth within any narrow limits is gravely hampered by self-imposed institutional and policy constraints. For the present these factors are causing an unnecessary and unintended tightness in monetary policy; in the future as in the past they could just as easily result in and undesirable overexpansion of the monetary aggregates. To see how this is so we must now examine the mechanism and its consequences.

The quantity of money in almost all modern economies can generally be analysed as the result of the interaction of three distinct groups. In the first place there are the monetary authorities - the federal government and the central bank - who together determine the quantity of highpowered money or the monetary base. As in Britain and in Canada, the composition of the monetary base in Australia is rather more complex than in the United States or Japan, consisting of liabilities issued

AUSTRALIA

CHART 2 : MONETARY BASE AND COMPONENTS



not only by the Reserve Bank (Australia's central bank), but also by the Australian Government.

The second set of participants determining the quantity of money is the commercial banks who can influence the money supply because they have some leeway to increase or decrease the ratio of their deposits to reserve assets. Third, the general public (that is all individuals, companies, and other entities which are neither banks nor part of the monetary authorities) can affect the money supply by altering the amount of deposits they hold relative to cash currency.

It is important in pursuing this analysis to ensure that the various definitions of money, the monetary base, reserves, and cash currency are all consistent. For consistency the most satisfactory monetary aggregate to use in Australia is M_2 , which includes deposits at All Trading Banks, and not M_3 despite the fact that the authorities focus on this particular definition in setting their monetary targets. The reserve assets of All Trading Banks can be readily computed from published statistics, and the remaining figure for cash currency held by the public is not significantly altered by shifting from M_3 to M_2 . (Savings Banks hold a negligible quantity of cash currency.)

The contribution of the three groups to changes in the money supply over recent years can be examined in the following way:

Contributing Group	Summary Statistic
Monetary Authorities	Money Base (or its growth)
All Trading Banks Non-Bank Public	Deposit-to-Reserve ratio } Components of the Deposit-to-Currency ratio } monetary multiplier

The dominant influence on the growth of the Australian money supply has been the growth of the monetary base as illustrated in Chart 3. The chart shows the main factors responsible for fluctuations in the growth of the monetary base over the period. Until the end of 1972 foreign exchange reserves were rising due to a deliberate policy decision of the authorities implemented by the Reserve Bank to peg the Australian dollar exchange rate to the U.S. dollar at a time when demand for Australian dollars would have driven up their price in a free market. In order to peg the price the authorities had to supply Australian dollars to the banks (who were the main sellers of US dollars on behalf of their clients), causing the absolute level of bank reserves to accelerate and setting in train a more rapid growth of the money supply. From 1973 the situation was reversed. The balance of payments had switched to deficit, and to maintain a fixed price of Australian dollars in terms of US dollars, the authorities now had to sell foreign exchange reserves. The sale of US dollars and the corresponding purchase of Australian dollars caused the converse set of effects. The absolute level of bank reserves declined, and the base decelerated, closely followed by the money supply. From 1975, however, a new element took over in the shape of a swelling federal government budget deficit. To finance the deficit the government issued large amounts of securities, many of which were purchased by the Trading Banks and were therefore added to their reserve assets. The larger supply of reserve assets fueled a second wave of monetary expansion in 1975-76, and it was not until the deficit really began to shrink in 1977 that Australian monetary growth began to be reined in.

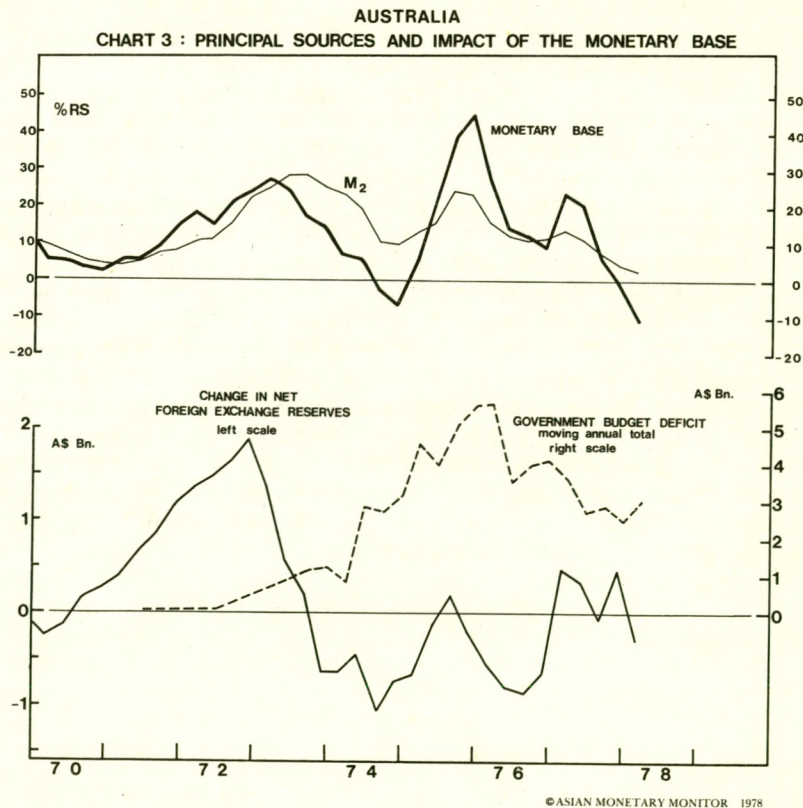
Discrepancies in the relationship between the monetary base and the money supply are explained by changes in the monetary multiplier, or the ratio of the money supply to the base shown in Chart 4. The constituents of the monetary multiplier can be further divided into ratios which summarise changes in the behaviour of the banks or changes in the behaviour of the public. The deposit-to-reserve ratio of the banks is illustrated in Chart 5. Bank reserves consist of Statutory Reserve Deposits (SRD) plus Liquidity and Government Securities (LGS). In conventional terminology these ratios are expressed in the form of a percentage of deposits, but if they are inverted and expressed as a ratio to deposits, it is visually easier to relate upward movements in the deposit-to-reserve ratio to an acceleration in monetary growth. Conversely, in the absence of other changes a downward movement in the deposit-to-reserve ratio would be associated with a deceleration in monetary growth.

Similarly, upward and downward movements of the deposit-to-currency ratio would normally correspond to accelerations and decelerations in monetary growth.

Implications for Monetary Policy

Given the behaviour of the monetary base, the Reserve Bank in recent years has tried to counteract major upward or downward fluctuations by altering the SRD ratio, but because the SRD ratio is arithmetically of small significance in the monetary multiplier, the overall effect in moderating movements of the money supply has been limited. In 1974, for example, when the monetary base was decelerating very sharply the SRD ratio was eased successively (in the Chart D/SRD rose for three successive quarters), while in 1975-76 the Reserve Bank attempted to counter the overexpansion of the monetary base with a tightening of the SRD ratio (in the chart, D/SRD fell while the monetary base was accelerating upwards). A precisely similar pattern was repeated on a more modest scale in 1976-77. The recent overcontraction of the base suggests the Reserve Bank will once again ease SRD ratios in 1978. However the impact on the base and on the money supply are again likely to be limited, and the source of monetary expansion - when it comes - will probably emerge from another direction.

The institutional constraint which has affected the Reserve Bank's ability to regulate monetary growth is the LGS



convention. LGS assets are defined as notes and coin, cash with the Reserve Bank, Treasury bills and notes and other Australian Government securities. According to an official publication,* "the LGS convention is a formal expression of certain firm understandings which were reached between the central bank and the major trading banks in 1956; it has no statutory basis. Under the convention each bank undertakes to direct its policy to ensuring that its LGS ratio (ratio of LGS assets to deposits) does not fall below the agreed minimum which is uniform for all major banks." Because government securities in Australia count as reserve assets for the banks, variations in the government budget deficit have had a direct impact on the monetary base and hence on the money supply, whereas in Japan or the USA this is not so. The basic problem with this type of multiple reserve asset system which applies both in Britain and Canada as well as in Australia is that it confuses the concept of sound bank management (i.e. the prudent matching of the maturities of assets and liabilities) with sound monetary management (i.e. the appropriate supply of money for a given level of real output). Enforcing the LGS convention in pursuit of the first of these objectives has frustrated the achievement of the second at a time when ballooning government budget deficits led to a rapid growth in bank holdings of government securities. With the present Fraser administration striving for a reduction in the budget deficit there is likely to be continued pressure on bank liquidity and hence a contractionary impact on the monetary base from this source.

The policy constraint affecting monetary growth is the pegging of the exchange rate, as explained above. However in this case instead of contributing to any further decline in the base, at this stage in the cycle the net foreign exchange position is likely to start rising, and could even rise very sharply. In the first place imports are falling and could decline further with the slackness in the level of domestic economic activity. Exports, particularly to Japan, are starting to recover with the upsurge in the Japanese economy and the revaluation of the yen vis-a-vis the Australian currency. Interest rates are high but falling and are likely to attract funds for fixed interest investment, and with a sharply lower inflation rate Australia's export competitiveness relative to the US or Canada and other competitor areas will encourage capital investment in the country. (In addition, recent government measures have relaxed the restrictions on foreign ownership.) In summary Australia is almost certain to switch from its balance of payments deficit to a surplus within this year, and as long as the Authorities peg the exchange rate this will again result in expansion of the monetary base and acceleration in the money supply.

* Reserve Bank of Australia, Functions and Operations (1973)

AUSTRALIA

CHART 4 : THE MONETARY BASE, MULTIPLIER, AND M₂

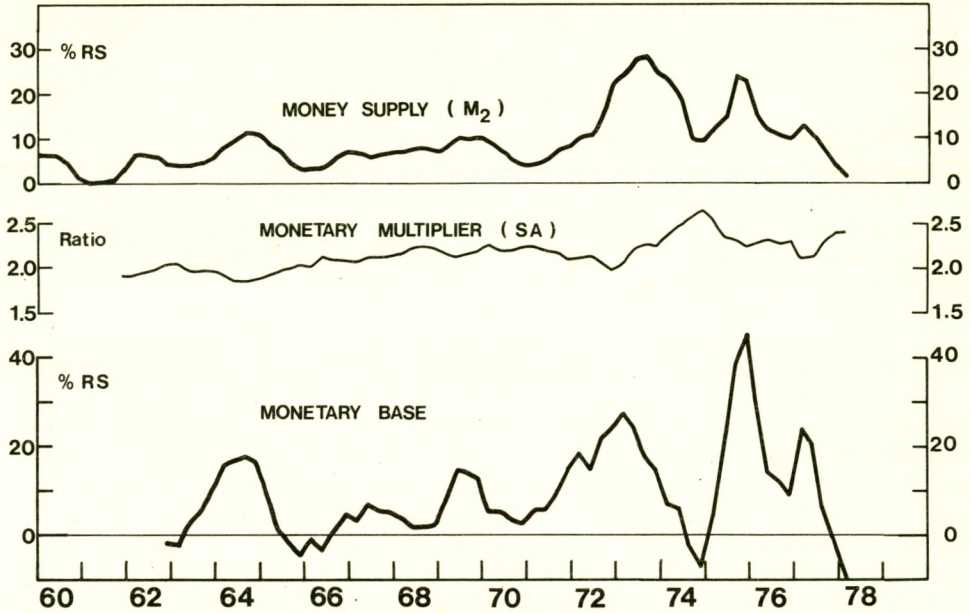
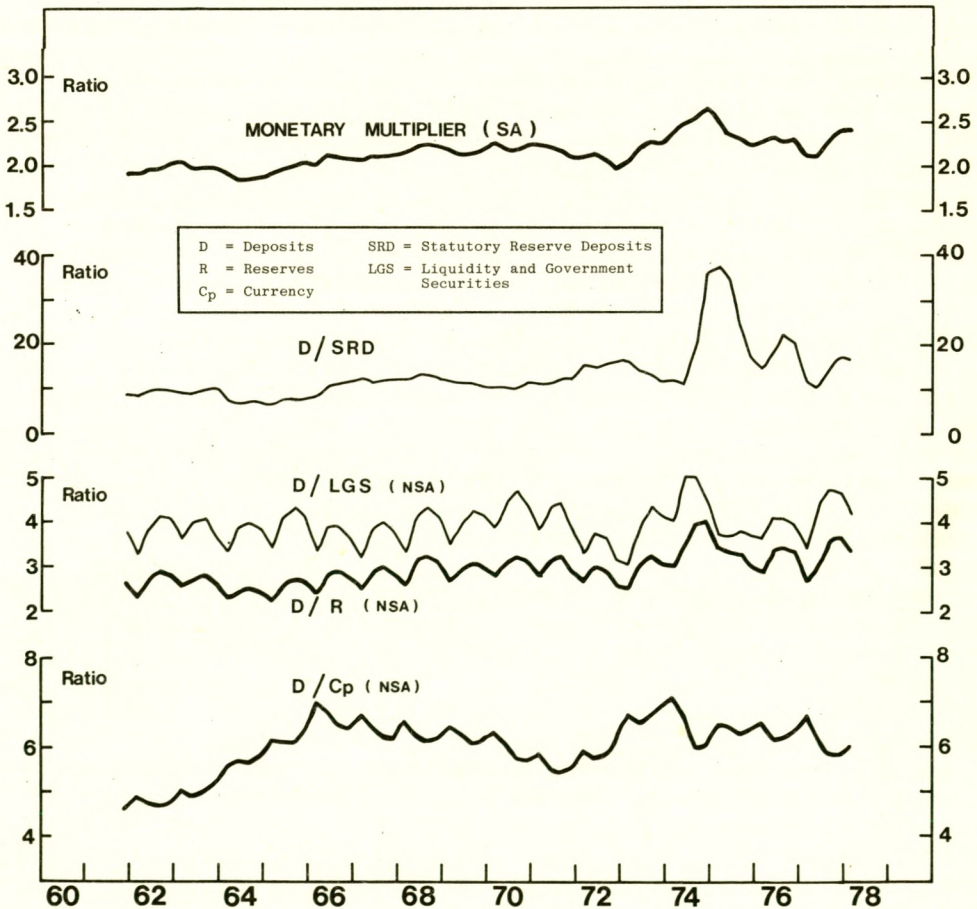


CHART 5 : MONETARY DETERMINANT RATIOS



NSA - Non Seasonally Adjusted (quarterly data)

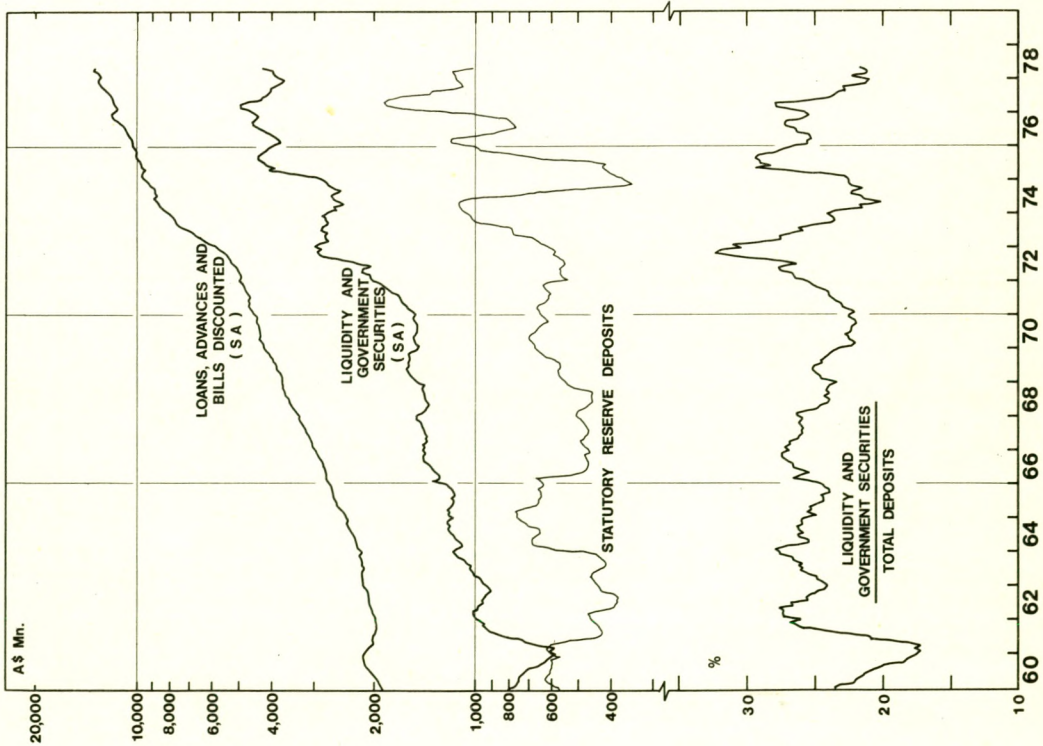
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FORECAST: Australia has been going through a sticky time. To date the results of the prolonged monetary squeeze have been limited - the painful side effects are there for all to see while the beneficial consequences are not yet widely apparent.

Unintentional overcontraction of the monetary aggregates has depressed economic activity at home, raised the level of unemployment, and discouraged investment. On the external side the balance of payments has been reacting mainly to the previous policy of monetary overexpansion which led to an increased demand for imports just at the time when demand for Australian exports was particularly weak. In addition, the fact that the currency was pegged and the balance of payments was in deficit led to destabilising speculation: because for multinationals and numerous other foreign investors the holding of profits or dividends in Australian dollars was overtly risky there was steady selling pressure against the A\$ currency from this source. To counter these problems on the trade account and on private capital account the authorities were compelled - so long as they pegged the exchange rate - to embark on a programme of borrowing abroad. The spectacle of a country rich in mineral wealth and long considered a far safer home for long term capital than either Southern Africa or Latin America going cap in hand to the international money markets in order to shore up her balance of payments has not been a happy one, particularly when the reason for the balance of payments problem was essentially a rigid adherence to an outmoded exchange rate policy.

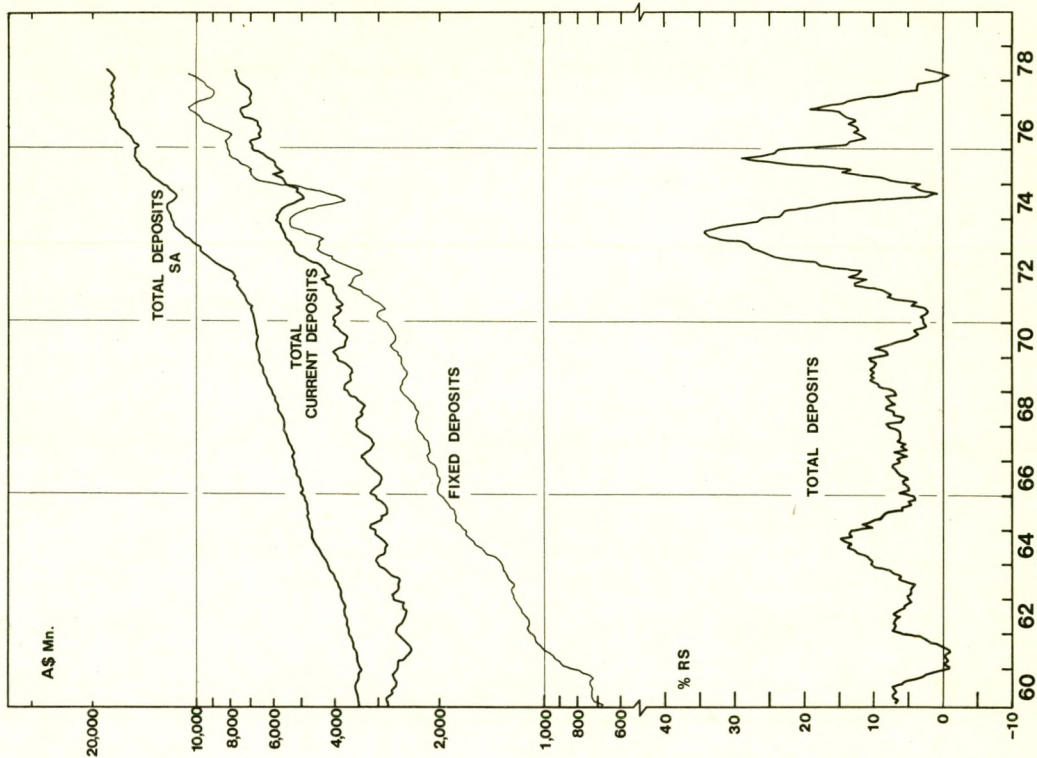
Turning to the brighter side, from now onwards the results of the prolonged squeeze will start to appear domestically in lower interest rates and a lower inflation rate. Currently interest rates are declining because the economy is in the second phase of a monetary squeeze: slack demand for credit rather than any excess supply of money is the reason for falling interest rates. Because the next phase of monetary policy will be an acceleration of money growth against a background of continued economic slackness, interest rates can be expected to fall further in the months ahead both at the long and short ends of the yield curve. Also, with inflation declining and the money supply accelerating real money balances or real purchasing power will be growing, bringing in its train a recovery in the domestic economy. Externally a balance of payments turnaround is still in its infancy, but by the end of this year or mid-1979 substantial surpluses and an "inflow" of private capital rather than deficits and an "outflow" will constitute the major problem. Indeed, if the authorities intervene to hold down the exchange rate and build up foreign exchange reserves as seems likely given the long tradition of official intervention, the balance of payments surplus will itself contribute to another cycle of monetary expansion. In the short term the results will be bullish for the Australian fixed interest and equity markets, but longer term, at least until the Australian authorities correct the institutional deficiency in the banking system and abandon their policy of pegging the exchange rate (in the way that Japan has done), the financial markets will again be subject to monetary instability. Meanwhile Australia will enjoy a cyclical recovery but not secular stability.

AUSTRALIA
CHART 6 : BANK ASSETS
(MAJOR TRADING BANKS)



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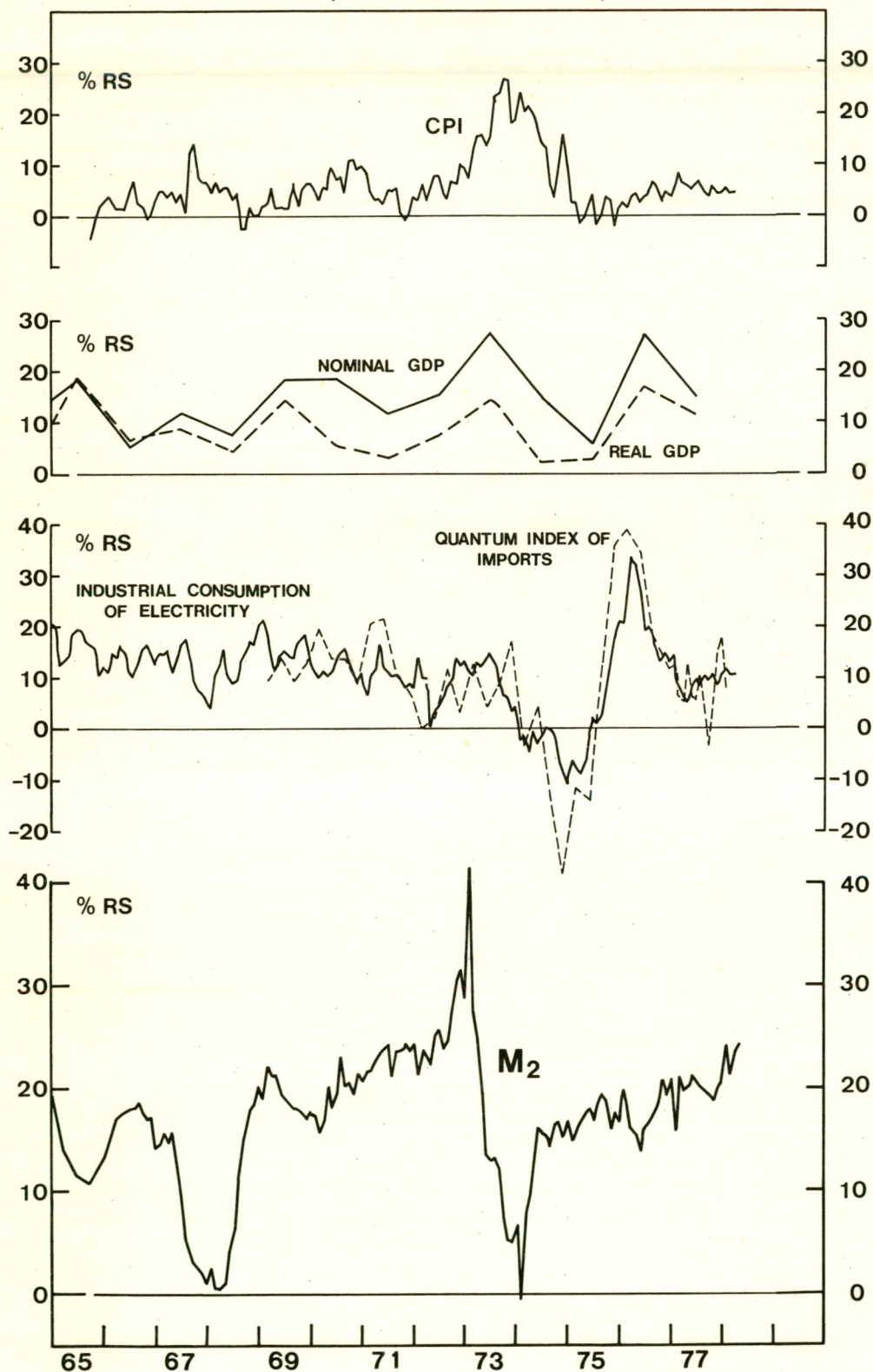
AUSTRALIA
CHART 7 : BANK LIABILITIES
(MAJOR TRADING BANKS)



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HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



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HONG KONG

ANOTHER STOCK MARKET BOOM ?

On Thursday June 15th, the Hang Seng index reached 546.54 after a rise of 14.5% in ten days taking it to the level it reached in October 1972. The turnover on the four stock exchanges in Hong Kong was HK\$249.23 million on that day alone. The strength of the 1978 bull market has inevitably been compared with the performance of share prices in 1972-3, but the similarities of the two periods extend beyond the confines of the stock exchange floor. What do the two periods have in common, and how do they differ?

In the two years 1976 and 1977 GDP grew a spectacular 31% in real terms - by far the most vigorous period of expansion since 1965. In both years Hong Kong's balance of trade deficit was unusually low, equalling only 3.7% and 7.1% of GDP respectively. In contrast 1971 and 1972 were not such expansionary years, GDP grew only 10.6% in real terms and the trade deficit equalled 14.7% and 9.8% of GDP. In other words the stockmarket boom of 1972 began when the Hong Kong economy was at an earlier stage in the business cycle whereas in 1978 the economy was entering its third year of vigorous growth. In both years consumer prices were rising at about 5% p.a. (see Chart 1) but in 1977 the GDP deflator - a much broader indicator of inflation - rose only 3.4% compared with 7% in 1972.

The main similarity between 1972 and 1978 is to be found in the trends in monetary growth. In 1978 M_2 was again growing at around 24%, as in 1972. This is undoubtedly rather a high rate compared with nominal GDP growth of about 15% in both periods and implies that monetary growth during both stockmarket booms was expansionary. Another rather curious parallel is in the rapid growth in demand deposits. Normally M_1 has grown erratically somewhere around 5% per annum slower than M_2 , but in both periods (from the 2nd quarter of 1972 and the third quarter of 1977) the rapid growth in demand deposits reversed the customary relationship, and for the past nine months M_1 has been soaring ahead. (See Chart 2.)

In many countries it has been observed that growth in M_1 is closely related to current economic activity or - more strictly - current transactions whether they are the buying and selling of goods, property or shares. A decline in the relative sizes of time and savings deposits relative to demand deposits indicates that the advantages of holding money on demand for these transactions purposes are outweighing the returns on time and savings deposits. In other words, if the banks wish to restore the liability structures of their balance sheets they must offer higher rates of interest on time and savings deposits. Examination of the movements of interest rates in 1972 and 1977-8 bears out this hypothesis (Chart 2).

In both periods the interbank rate began to rise until it was persistently above the Best Lending Rate - the best rate at

which the Hong Kong and Shanghai Bank will lend to borrowers. The latter rate was then raised early in 1973 in the first episode, and on May 1st this year in the more recent episode. The movements in interest rates and the gradual rise in the ratio of advances to deposits indicate that the banks are no longer as highly liquid as they were reported to be a year ago, and that there is a rapidly rising demand for loans just as there was in 1972. The difference in the cycles is basically in the timing. In 1972-3 the cycle was accelerated: from the slack of 1971 to the stockmarket peak in March 1973 was less than two years. On the other hand by 1978 the economy had experienced more than two years of rapid growth yet the banks are still reported to be liquid and interest rates are historically low.

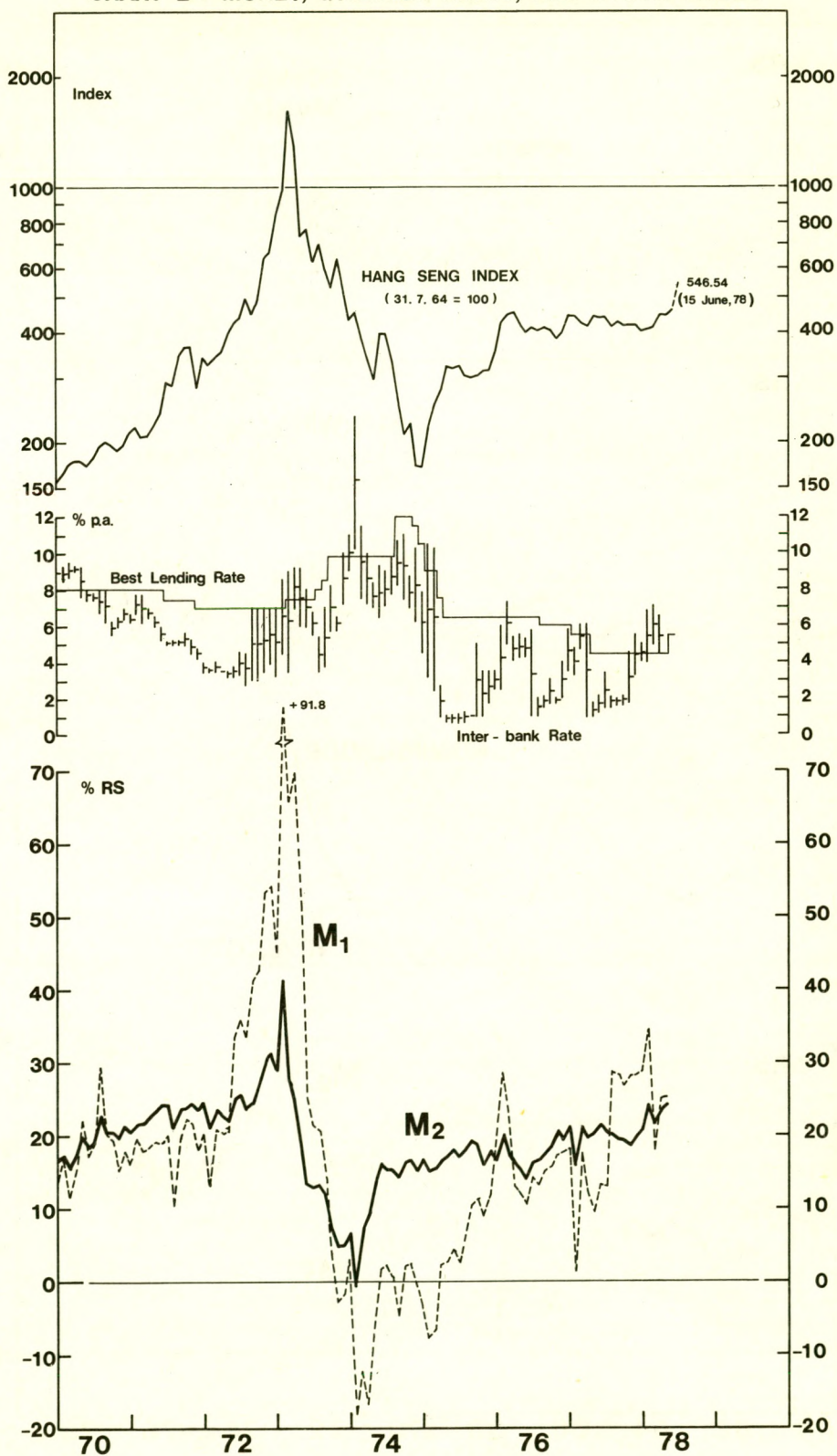
In both cycles the two classic outlets for high domestic demand, the property and stockmarkets, have responded. The property market was very strong in 1972 and 1977 but the stockmarket has failed to move in this cycle until the past few months in complete contrast with the tremendous and notorious boom of 1973. Overall then, the similarities are striking; money, interest rates, the property market and now perhaps the stockmarket are all moving in the same direction. What are the differences?

The most crucial difference from an economic point of view is the fact that in 1972 the Hong Kong dollar was pegged to the US dollar but in 1978 the Hong Kong dollar floats. The effect of this is to reduce the effect of those external influences on Hong Kong's money supply, which played such a large part in the monetary developments in 1972 and 1973. Though no figures are published it is likely that there was a large increase in the foreign reserves of the banking system prior to the revaluation of the Hong Kong dollar against the US dollar in early 1973 and that there was a subsequent fall in reserves which brought about the sharp contraction in the money supply. Under a floating exchange rate such rapid inflation and deflation of the money supply deriving from changes in the balance of payments are less likely. The monetary stimulus to a stockmarket boom therefore will probably not be so vigorous, nor will the bull market be so dramatically brought to an end by a monetary contraction. The monetary background to the current bull market is thus similar but unlikely to be as extreme as last time round.

Aside from the economic factors affecting the stockmarket there are several institutional factors which have altered since 1973. A Securities Commission now oversees stockmarket activity. All share dealers must now be registered and there is a total ban on short-selling, option dealing and forward trading. The Hong Kong Code on Takeovers and Mergers now regulates takeover bids and attempts to protect offeree shareholders from undue influences and deception. These and other measures all attempt to prevent a repeat of the abuses and market hysteria which marked the boom of 1973, but it is doubtful if they could deter an escalation of speculative buying if market sentiments combine with the current favourable monetary and economic conditions - in which case the results could be spectacular.

HONG KONG

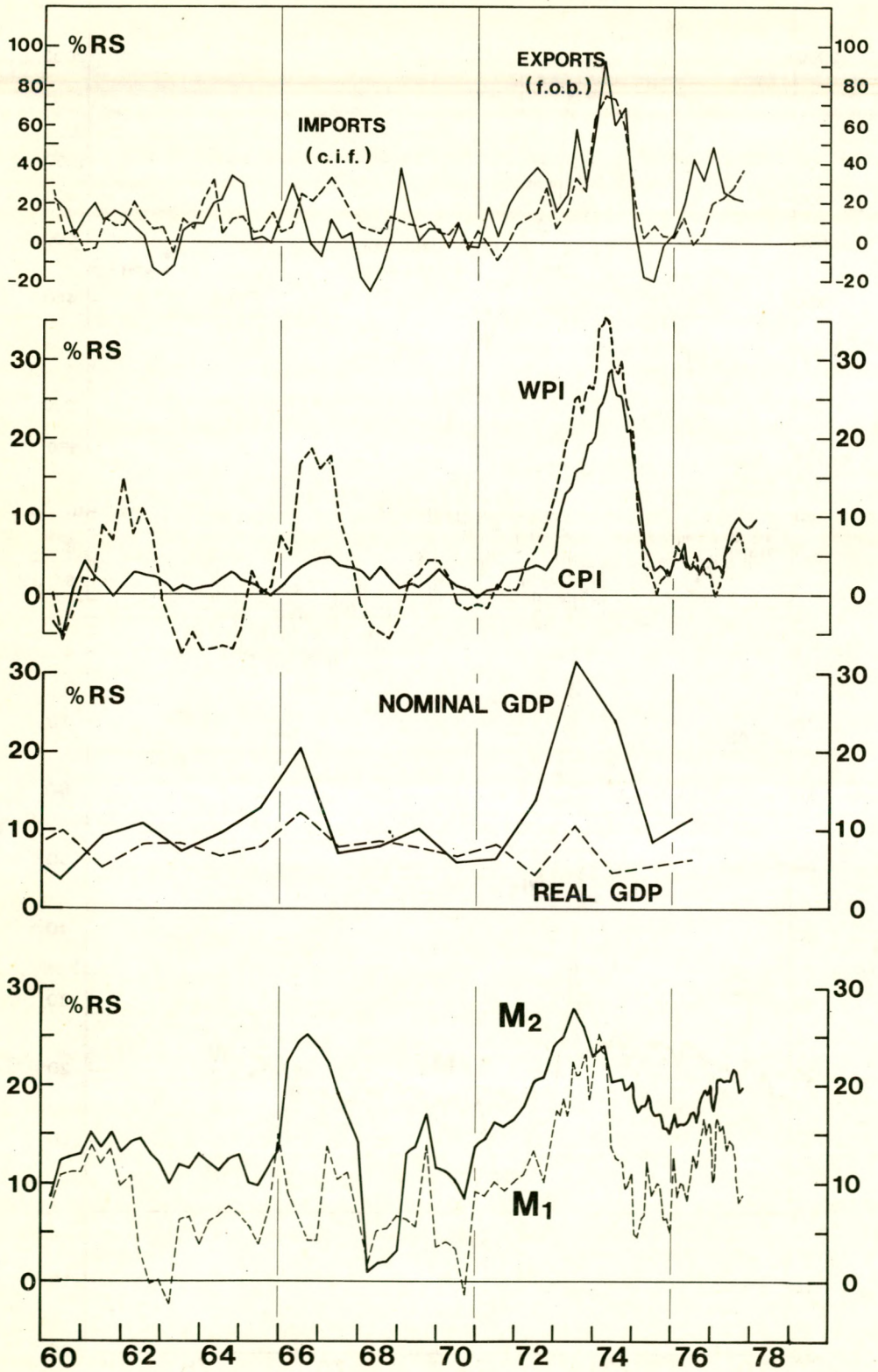
CHART 2 : MONEY, INTEREST RATES, AND STOCK PRICES



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THAILAND

CHART 1 : MONEY, OUTPUT, PRICES, AND TRADE



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THAILAND

THE BALANCE OF PAYMENTS AND MONETARY POLICY

The floating of the Baht early in March broke the tie to the dollar which has endured for 23 years. In part this reflects the current problems of the dollar, but it also reflects the fact that Thailand has been experiencing difficulties herself in the 1970s. The remarkable stability of the Baht exchange rate can undoubtedly be attributed to a considerable extent to the sagacious and consistent influence of the Bank of Thailand on economic policy since the Second World War. Despite many changes of government and political instability the consistent conservative influence of the Central Bank on the governments' economic plans helped to ensure an environment in which steady economic growth and foreign investment were encouraged.

From 1947 to 1955 Thailand operated a multiple exchange rate system but following the balance of payments crisis of 1954 the Bank of Thailand played a major role in the simplification and liberalisation of foreign trade regulations. In 1955 a new single parity for the Baht was established at a somewhat undervalued rate and the Thai balance of payments remained in surplus until the end of the sixties.

The Bank of Thailand also exerted a healthy influence on central government fiscal policies arguing strongly for balanced budgets. In its annual report for 1952 the Bank of Thailand warned: 'This practice of deficit financing is tantamount to credit expansion which leads to increase in the circulation of money and unless accompanied by a proportionate increase in production and services, there can only result in a rising price level and labour costs against which control and other measures cannot effectively cure.' - Sentiments at once both very old and ahead of their day.

The Bank not only influenced government policy in the traditional areas of the exchange rate and the budget but also in the government's interventionist policy. In 1959 the Bank was instrumental in persuading the government to withdraw from intervention in certain industries pointing out that none of the state-run enterprises were profitable and some were large drains on government funds.

The success of the Bank in maintaining monetary and economic order was due largely to its involvement in the formulation of government policy. Perhaps because of this, the Bank could afford to take a more passive role in its day-to-day operations in the financial system. Because of its success in ensuring the adoption of conservative macroeconomic policies which ensured the stable and moderate growth of monetary aggregates, in its management of discounts and the government debt the Bank was able to keep interest rates stable with little difficulty and throughout the 1960s many interest rates did not alter at all. However in the 1970s the stabilisation of interest rates has not been sufficient. Larger budget deficits and large fluctuations in foreign exchange earnings have made the role of the Central Bank more difficult, and the

enormous balance of payments deficit of 1977 is a consequence of the failure of the Central Bank to keep abreast of changing circumstances. Perhaps because the Bank has continued to place great emphasis on bank liquidity and interest rates the monetary aggregates have been allowed to grow at higher rates in the 1970s than in earlier years. This accelerated growth in the money supply has been manifested in a deteriorating balance of payments and domestic inflation.

The reasons for the higher rate of growth in M_1 and M_2 in the 1970s can be traced in the growth of the monetary base. The monetary base consists of the reserves of the banking system and notes and coins in circulation with the public. There have been some studies of the monetary base in Thailand which show the stable relationship it bears to the money supply.* Changes in the monetary base are closely paralleled by changes in M_1 (see Chart 3). Broadly the factors affecting the monetary base can be divided into two categories corresponding to the external - or balance of payments - component and the domestic policy component. Since 1955 the balance of payments component has been by far the more important factor: when the balance of payments has been in surplus the foreign assets of the Central Bank have grown rapidly and the balance of payments component has been the main stimulus to expansion of the monetary base. Only since 1969 has the domestic policy component been very significant.

From the late fifties until 1966 the Treasury deficit had always been quite small but in that year and subsequent years it grew rapidly. Whereas in 1966 and 1967 it was financed mainly by borrowing from the commercial banks and the government savings bank, in 1968 a substantial portion came from drawing down Treasury cash balances; but in 1969 the government relied heavily on borrowing from the Central Bank and this offset the contractionary effect of the large balance of payments deficit on the monetary base.

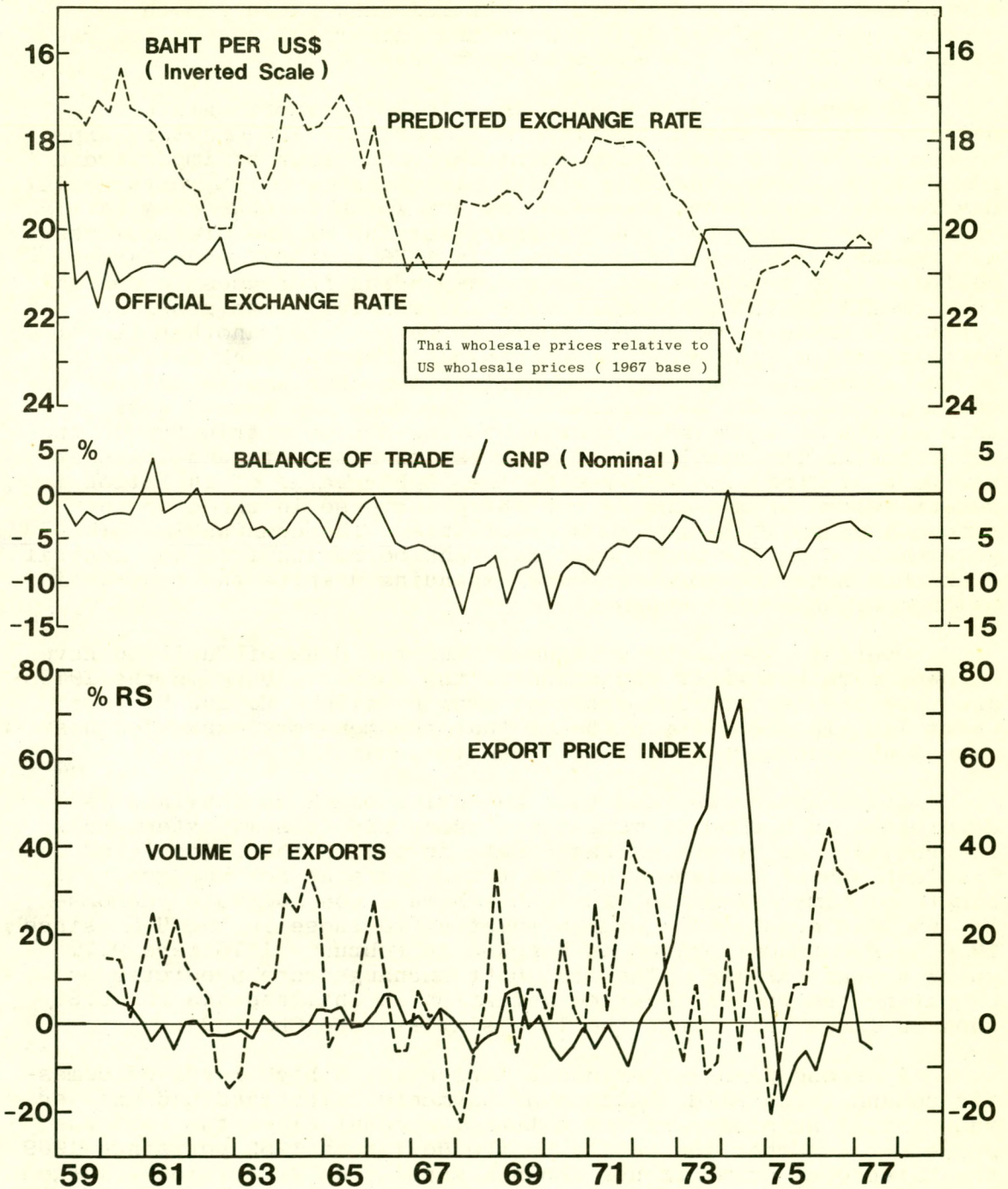
The stimulus to the supply of money at that time probably contributed to prolonging and deepening the balance of payments deficits in the two subsequent years, through its effect on aggregate demand in the Thai economy. It was not until the soaring world commodity prices caused Thai export earnings to grow rapidly in 1973 and 1974 that the balance of payments returned to surplus.

A notable feature of Thai fiscal policy is the tendency of the budget deficit to be reduced as the balance of trade strengthens: this is partly the consequence of a heavy reliance on ad valorem indirect taxes particularly on exports, but it also derives from the domestic rice price stabilization policy. When the export price of rice is high the government increases the tax on rice exports to prevent rice being diverted from the domestic market. In 1973 an alternative method was used which was unsuccessful so it was only in the following year that the treasury balance showed a large surplus and the government was able to reduce its debt to the Central

* The most notable is a paper by Sataporn Jinachitra appearing in 'Finance, Trade and Economic Development in Thailand' edited by Prateep Sondysuvan. Sompong Press 1975.

THAILAND

CHART 2 : TRADE, RELATIVE PRICES AND EXCHANGE RATE



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Bank. As a result of this delay the balance of payments component of the monetary base generated an acceleration in the money supply which was not fully offset by the contractionary effect of the fiscal policy. In an attempt to restrain the rapid growth in credit the Bank of Thailand raised the commercial banks' reserve ratio from 7% to 8% for six months in 1974.

As world commodity prices fell in 1975 export earnings declined but the lagged response of imports to the monetary expansion in the previous years meant that the value of imports did not decline, resulting in a substantial balance of payments deficit. Government expenditure increased by 30% while revenue grew barely 3% with the result that the Treasury surplus of the previous year was replaced by a record deficit. In 1976 and 1977 even larger deficits were recorded and the corresponding increases in central bank credit to the government kept the monetary base growing rapidly. Moreover in recent years there has been another factor contributing to the monetary expansion: Central Bank net lending to the commercial banks grew rapidly after 1973 and in 1977 it was the major cause of the expansion in the monetary base. Perhaps this growth in commercial bank borrowing can be attributed to the reduction in the real rate of interest on discounts and loans at the Bank of Thailand - caused by the higher rates of inflation in recent years, if so, the recent sharp increase in the discount rate may go a little way to correct this. The combination of government deficits and commercial bank borrowing from the central bank thus kept the monetary base expanding despite the contracting balance of payments component.

Overall, then, the government and the Bank of Thailand have allowed a rather rapid expansion in the monetary base in the 1970s and this has led to high rates of growth in both M_1 and M_2 (see Chart 1). Is there any evidence that the monetary expansion has caused an excessive growth in domestic demand?

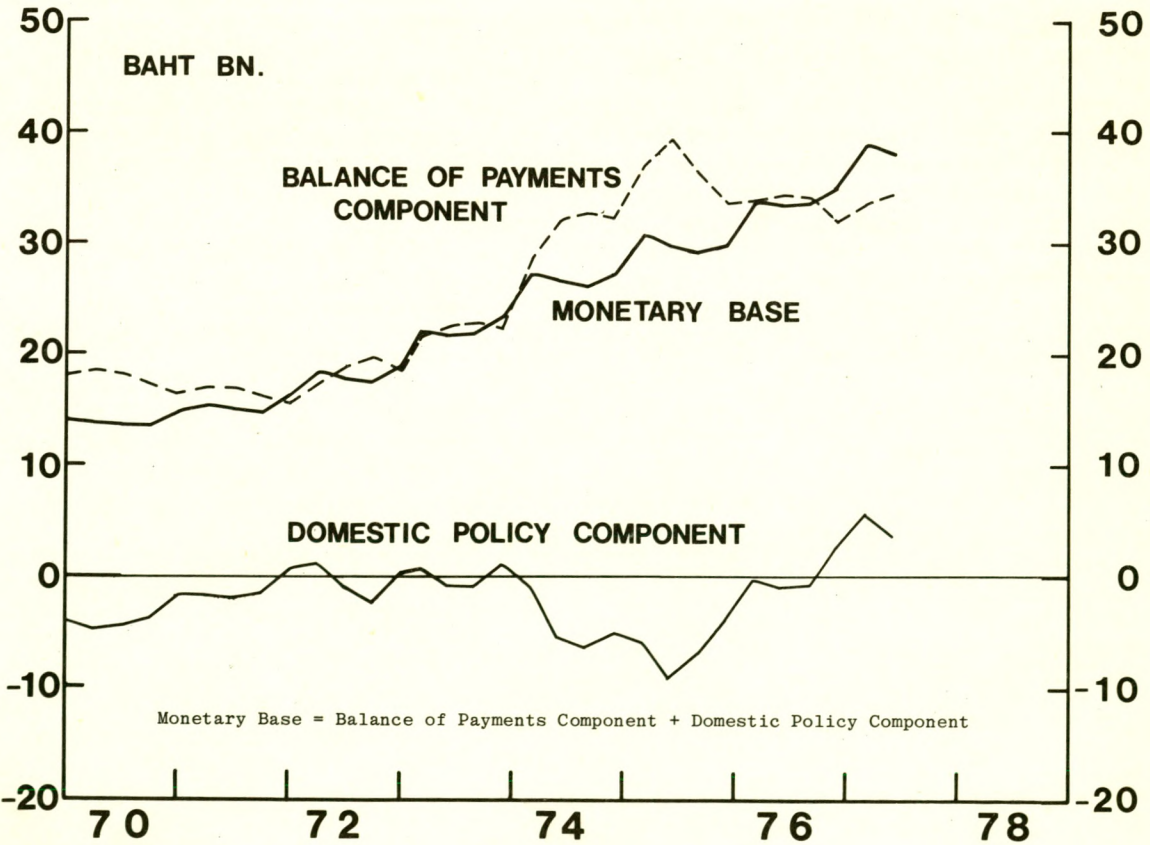
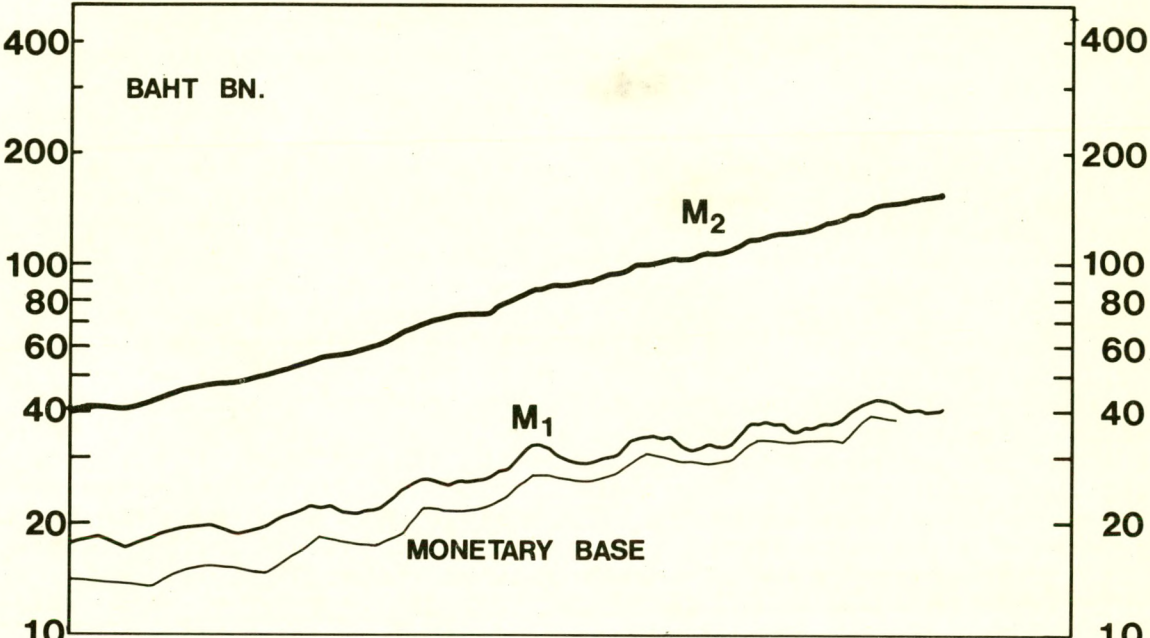
It is often asserted that the price level in Thailand is determined in commodity markets overseas and to some extent this is true, for while the exchange rate is pegged the price level in Thailand cannot deviate from the trend overseas for any great length of time. Even so, there has been a considerable increase in Thailand's wholesale prices relative to those in the U.S. since 1970, and consumer prices in Bangkok in February 1978 were 9.7% up on a year earlier. The Thai Baht exchange rate predicted by comparing the wholesale price inflation in Thailand and the U.S. shows a large fall since the late sixties (see Chart 2).

A second piece of evidence indicating a high level of domestic demand is the weak balance of payments. Thailand had enjoyed substantial surpluses on the external account since the Baht was pegged at a rather low parity to the dollar in 1955 yet since 1969 the balance of payments has shown a secular deterioration - large surpluses have been recorded in only two years.

A third possible indicator of excessive monetary growth is the stockmarket boom. The stirring of the stockmarket from comatose slumber in 1977 may in part have been encouraged by the monetary expansion in recent years rather than the attempts by the government to prod it into life.

THAILAND

CHART 3 : MONEY AND MONETARY BASE



In the light of this monetary analysis the government's recent economic measures can be evaluated. The steps taken by the government to curb imports and the current tendency to blame the balance of payments deficit on high fuel costs do not in fact attack the cause of the balance of payments deficit. Instead attention should be directed towards means of restraining domestic demand by controlling the money supply.

The decision to raise the discount rate from 9% to 10½% reducing the attractiveness of borrowing from the Central Bank and the imposition of ceilings on credit extended by financial institutions will both help to restrain the growth of monetary aggregates, and thereby curb domestic demand. However in the longer run the Bank must either ensure that government deficits are reduced, or encourage the development of financial markets and institutions which will enable deficits to be financed in non-inflationary ways. In the meantime, it is too early to say whether the February measures will slow monetary growth sufficiently. It is fortunate that the US dollar has been weakening on the foreign exchanges at a time when the Thai balance of payments has been deteriorating. The weakening of the dollar and with it the Baht has already caused a considerable devaluation of the Baht relative to the currency of Thailand's major trading partner Japan, but if the present rate of monetary expansion in Thailand is maintained the Baht will undoubtedly fall further relative to the yen.*

FORECAST: As the exchange rate is not being floated but only being 'managed' relative to a composite of currencies, movements in the Baht exchange rate in the short to medium term will be matters of policy not market forces. At the moment the authorities should have little difficulty in maintaining the quarter-century old exchange rate with the US dollar, but for Thailand the yen/baht rate is more important: if M_1 and M_2 continue to grow at over 20% and 12% per annum respectively the balance of payments deficit will continue and there will be pressure on the baht to weaken relative to the Japanese currency. The Bank of Thailand's attempts to restrain credit expansion in the face of double digit inflation also mean high interest rates throughout this year.

* In 1976 26% by value of Thai exports went to Japan and 32% of Thai imports came from Japan.

EPISODES FROM ASIAN MONETARY HISTORY

INDONESIA UNDER SUKARNO :

TO THE ABYSS AND BACK (Part 2)

After two years of political turmoil and rebellion Sukarno seized power in 1959. For several years the budget had been in deficit and the money supply had grown rapidly. In a drastic but ill-considered move he demonetized large denomination banknotes and confiscated bank deposits, causing an acute liquidity crisis. To relieve it there followed a rapid expansion in bank credit which soon made up for the cut in the money supply. This 'Sukarno Axe' was the first major move by Sukarno after launching the country into 'Guided Democracy', and it marked the beginning of six years of economic and political chaos during which government policy lost all sanity and rationality. Budget deficits grew larger and larger as the tax and foreign exchange systems collapsed, and price inflation soared to a peak of 100% per month in early 1966.

In this second article we review the evolution of the banking system and discuss the effects of inflation on the balance of payments and the demand for money. Finally the fall of Sukarno and the successful efforts of the military government to restore order in the economy are outlined.

* * * * *

The Guided Democracy

"Some of my personal friends are Capitalist Socialists," President Sukarno 1965.

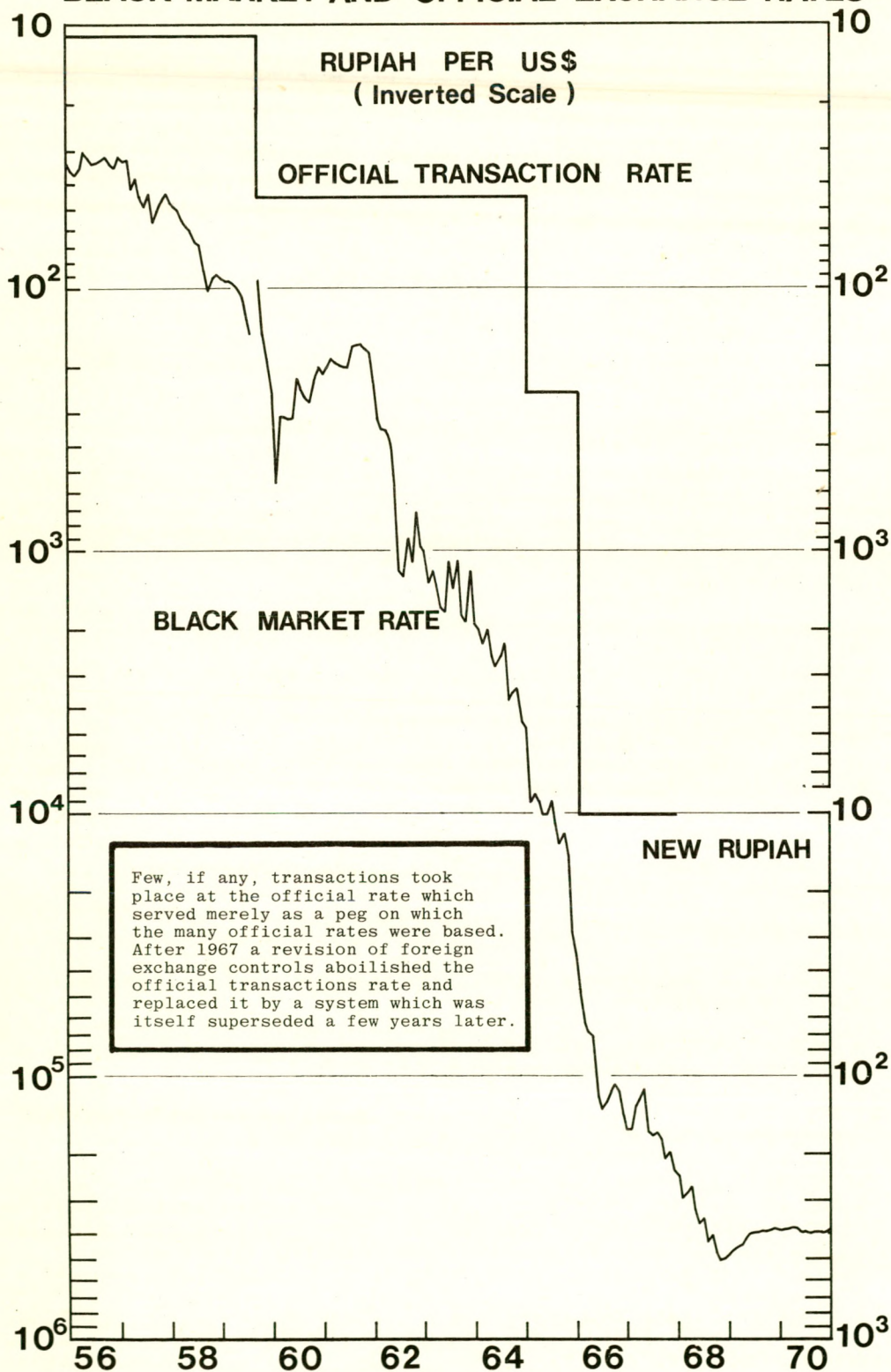
On July 5, 1959, President Sukarno decreed the reinstitution of the 1945 Constitution, and the period of Guided Democracy began. In practice the Republic of Indonesia reverted to the philosophy of 'Pantjasila' or Five Principles 'born amidst the Revolution' over a decade earlier. The main precepts by which Indonesia was henceforth to be ruled were "gotong rojong" and "kekeluargaan" or mutual cooperation and family feeling respectively, and the five principles, known by the acronym 'Usdek' :-

- 1) Undang - undang Dasar 45 (return to the strong presidential government of 1945).
- 2) Socialisme ala Indonesia (in effect redistribution of wealth).
- 3) Demokrasi Terpimpin (Guided Democracy) or in other words Sukarno was to be supreme authority.
- 4) Ekonomi Terpimpin (Guided Economy) or the concentration of economic power in the hands of the State.
- 5) Kepribadian Indonesia (Indonesian Identity) or sabre-rattling foreign policy and nationalistic gusto.

The President himself was given grandiose titles such as 'Great Head of the Revolution' and 'President for Life'. But nevertheless, he did not enjoy unlimited power; because his power derived from a delicate balance of political forces, he dared not move too far in any one direction for fear of losing the support of one faction or another.

"In essence Guided Democracy was a palace or court government, in which the privileged participants endeavoured to extract for themselves the maximum power base from the national pool, and to acquire the financial resources to operate and consolidate it. It is, of course, impossible to credit that the President did not desire power, and his love of the

INDONESIA BLACK MARKET AND OFFICIAL EXCHANGE RATES



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trappings of power remained notorious to the very end. But it was essentially power without responsibility that Sukarno desired, 'the privilege of the harlot throughout the ages' as Britain's Prime Minister Stanley Baldwin once described it. If this was not a very practical goal, it was one that he shared with many other prominent Indonesians."*

Thus Sukarno's room to manoeuvre was constrained by the Army, the Communists and the Muslims, and this was reflected in the Usdek principles, vague though they were. Indonesia was to be guided along a path of economic development which, while not being 'communist' because of strong Muslim opposition to any atheist doctrine, was not capitalist either because the communists would object. Sukarno himself claimed he was not a communist though he was closely associated with the communist party. The important thing for everyone was that Guided Democracy should be essentially Nationalist and uniquely Indonesian. What emerged in fact was a heavy-handed state paternalism which severely discouraged private enterprise while doing little to replace it. The Bank Indonesia in justifying State control of 'vital' economic activities explained: "The State constitutes the Indonesian family at large and is the 'gotong-rojong' - entity. Hence it is only natural to surrender vital economic projects to the State."

'Non-vital' economic activities could continue to be carried out by non-Government entrepreneurs but it was strongly recommended that entrepreneurs join forces 'in the shape of cooperatives' in the spirit of "gotong-rojong", but - lest there was any mistake about the meaning of this - where cooperatives proved unfeasible or unwarranted, cooperation would be "sought along other lines" - and in a throw-away line - it was mentioned that the government could be expected to intervene in any field it chose to regulate economic activity.** Not surprisingly, the commencement of 'Guided Economy' led to a rapid emigration of many Dutch and Chinese people. They were encouraged on their way by Decree no. 10 of 16th November, 1959 which prohibited foreigners from trading in rural parts of Indonesia. The Decree thus hit mainly at the Chinese who were the mainstay of rural trading. As foreigners attempted to take their capital out of the country the currency blackmarkets were flooded with 'hot' money which sent the Rupiah rate plummeting. The blackmarket rate had started to decline consistently in 1958 but after 1959 the rate varied erratically as the market reacted to successive political shocks.

In Part I it was shown that the inflation of the early 1960s was caused by budget deficits arising from incompetent administration and an inadequate tax system which placed an excessive burden on foreign trade. By undermining nominal tax rates and increasing the incentives to illegal trade the inflation further widened the budget deficits and thereby caused yet more money to be printed. Thus the process of inflation was self-reinforcing through its effect on the fiscal budget of the government.

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* 'Indonesia' by Donald W. Fryer and James C. Jackson.

** The Bank Indonesia Annual Report for 1959 makes very enjoyable reading. Apart from many references to the difficult 'process of adjustment' to the new economic regime which was the cause of the dismal economic performance in the year under review, it also sets out the ideas behind Indonesian socialism, which was to represent "the sum total of the spiritual force and material conditions prevailing in Indonesia" and it goes on to explain the failure of private enterprise as being because "the spiritual nature and material identity of Indonesia were ignored."

The Effects of Inflation

Inevitably the cause and consequences of inflation are difficult to disentangle. No doubt the deterioration in economic activity contributed to inflation by restricting the supply of goods but it was also caused by inflation insofar as inflation interfered with the normal operations of the price mechanism. Inflationary expectations reduced the free flow of trade by prompting erratic and panicky attempts to hoard commodities. Indirectly, inflation further hindered economic activity by provoking misguided intervention in markets by the government in attempts to stabilise prices. In particular, strenuous efforts to hold the price of rice at preconceived levels led to distortions in the market and a severe misallocation of resources. These futile attempts at price control directed people's energy into non-productive activities where enormous profits could be made both by arbitrage between official prices and blackmarket prices and by hoarding in expectation of price increases.

There were two important consequences of inflation - one external and one internal. The external effect was on the balance of payments and the rupiah exchange rate. The internal effect which we will examine was the decline in the demand for money.

1) The Balance of Payments

Despite the rapid monetary expansion in the 1950's the balance of payments remained in surplus. At first sight this is rather surprising. In 1958 the money supply increased by over 50% and consumer prices rose over 20% yet there was a substantial trade surplus and even larger surplus on current account. This might have been expected if the balance of payments surplus had been the principle cause of the expansion in money supply through its expansionary effect on the monetary base, but this was not so: the monetary expansion was generated almost entirely by fiscal deficits. Thus a domestically generated high rate of monetary expansion was sustained concurrently with a balance of payments surplus. Similarly in 1959, both the trade balance and the current account were in surplus, and it was only in 1960 that the balance of payments weakened and not until 1961 that a really large deficit occurred. The reason for this surprisingly healthy balance of payments was the sheer physical difficulty of importing.

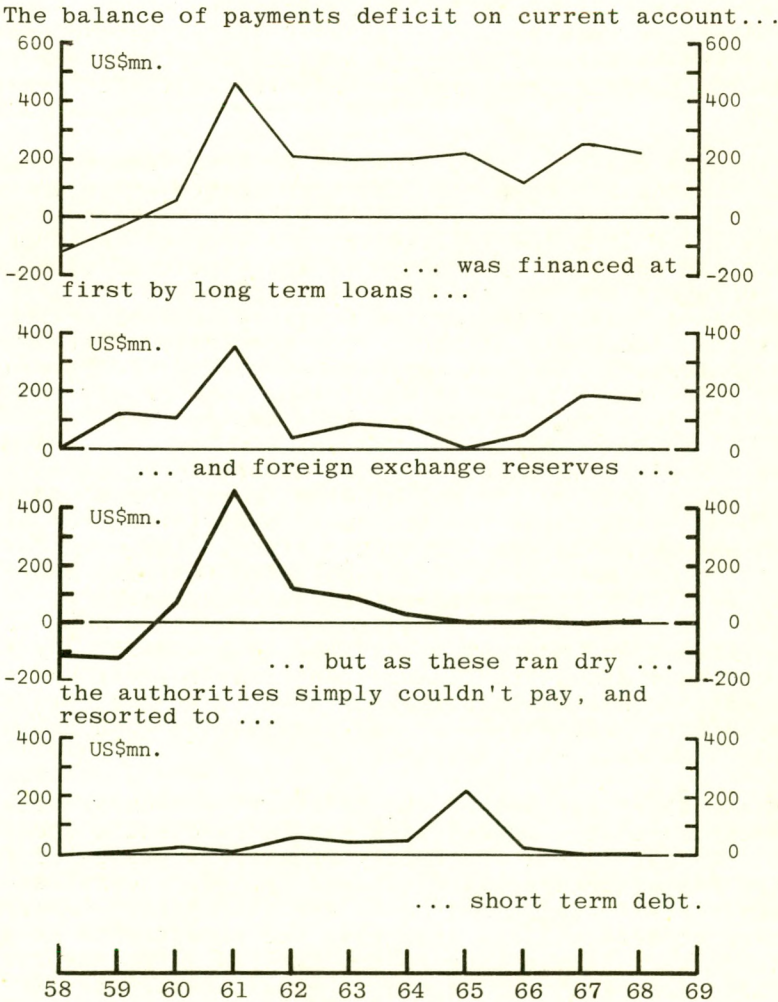
Not only was the bureaucratic foreign exchange system cumbersome and a serious deterrent to doing business through the official channels but also the government kept a strict control over the allocation of import licences and the banks were instructed to restrict credit to private importers. If that was not enough, the seizure of Dutch enterprises by the state disrupted established trading agreements and practices built in by the Dutch and further hindered normal trade. Compounding these problems were the monetary reforms in 1959 which forced many companies including State enterprises into an acute liquidity crisis and produced all sorts of bottlenecks, particularly in the administration of imports. Even the State enterprises which had priority, could not achieve their reserved allocation of imports. The result was that factories could not work because they lacked vital spare parts or raw materials, and even basic goods like cloth and paper were in short supply.

The Bank Indonesia acknowledged that the very great purchasing power in the community made the prices of imports unimportant and that quantitative restrictions were far more important in determining the import bill. "The volume of imports naturally did not reflect the community's need nor the effective demand for import goods.... The total of imports that could be realised....was clearly still far from adequate to cover the domestic need for consumer goods, auxiliary products, semi-fabricates as well as capital goods". Moreover, the goods that were imported were inappropriate: "In this connection, it may be noted that of said imports, rather an important part consisted of military goods"....."Hence it may be said there was a real thirst for essential goods...." Undoubtedly this acute shortage of

imported goods contributed to the extremely high rupiah prices charged for foreign manufactures, and the concomittant occurrence of hoarding in expectation of future price increases.

The availability of foreign goods varied considerably during the period of the Guided Economy but there were always shortages. In 1965 and 1966 many trucks and buses were immobile for want of spare parts, and factories were idle through lack of materials. Needless to say the high prices due to bottlenecks in official trade only served further to encourage smuggling. The throttling of imports in 1959 coincided with favourable world market prices for Indonesian exports and in particular rubber, so that export earnings rose considerably while imports stagnated, with the result that the authorities found they had quite substantial foreign reserves.

In 1960 therefore, it was decided to liberalise import controls on luxury goods to 'blot up' the tremendous accumulation of 'hot' money in Indonesia and thereby ease the inflationary pressures. The prices of cars fell, and the blackmarket rupiah strengthened as legal import channels became easier. Imports of clothing and footwear were encouraged and accordingly the price index for this category of goods fell from 694 in August 1960 to 504 in March 1961.



Unfortunately the government also attempted to keep prices of 'essential commodities' down by strict price control, so that while the supply and demand were allowed to determine equilibrium prices for luxury goods there were still acute shortages of basic foodstuffs such as rice and sugar because the price was not allowed to move to clear the markets. By their policy the government thus enabled the rich to buy luxuries at reduced prices while the poor were unable to get food at controlled prices.

The easing of import restraints in 1960 proved to be the crack in the dam. Accumulated effective demand due to many years of monetary debauchery was not to be contained any longer, and in the following year the dam burst completely. In dollar terms, imports in 1960 rose 20% over the previous year and in 1961 they rose a further 38%, with the result that the current account of the balance of payments showed a deficit of US\$59 million in 1960 and US\$463.5 million in 1961.

To make matters worse, flooding in Java hit rice production badly in 1961 sending the price of rice rocketing and increasing the need for rice imports. Also in 1962 monetary expansion shifted to a whole new order of magnitude. Hitherto M_1 had grown at less than 50% per annum but by the end of that year it had grown over 100%. In the face of such an explosion in effective demand, something had to give. The exchange rate system crumbled as domestic prices soared, absurd export subsidies and import taxes were tagged onto the official rate but were quite insufficient to compensate for the deteriorating domestic value of the Rupiah. Since the official exchange rate would not adjust, the adjustment was necessarily transferred to the balance of payments, which, despite the reimposition of tightened import controls, remained in deficit until all foreign reserves were exhausted.

Initially the deficits were financed by long term borrowing. Gradually, as Indonesia became more and more obstreperous in her foreign policy the loans dried up. In early 1963 Djuanda, Sukarno's Prime Minister, negotiated new loans from the IMF and the USA, but in the event the much needed dollars did not turn up because of international disapproval of Indonesia's 'Malaysia Confrontation' policy. Finally, to make matters worse, in 1965 in a lunatic gesture of defiance against western domination of world politics, Indonesia withdrew from the United Nations, the IMF and the IBRD (International Bank for Reconstruction and Development). Thus, by the end of 1964 nearly all sources of long term credit had been exhausted and the foreign exchange reserves had run dry.

Indonesia kept going mainly by loan and trade agreements with communist countries including most of the Soviet Bloc, North Korea and the People's Republic of China. Red China in particular benefitted from barter-trade arrangements whereby goods were exchanged without the need for foreign currency transactions and it is widely believed that she profitted enormously by reselling Indonesian rubber on world markets. In December 1965 more than 60% of Indonesia's medium and long term debt was due to Communist countries and most of it was due to the USSR. By that date Indonesia could only manage to finance her trade deficit by 'short term credit'. In effect this was not finance at all, it was merely the failure to pay debts in late 1965 she could not even honour cash letters of credit. In other words Indonesia was bankrupt.

One of the first actions of the military government after they had ousted Sukarno on 11th March, 1966 was to reschedule Indonesia's foreign debt. On 12th April the Deputy Premier in charge of Economic Affairs Sultan Hamengkubuwono IX disclosed that Indonesia was quite unable to meet her external commitments for that year. Compared with export earnings of \$715 million Indonesia had commitments to pay \$530 million, leaving very little over to buy imports. Not surprisingly one of the first organisations Indonesia rejoined was the IMF. The new government was forced to negotiate with a consortium of creditor nations in order to obtain rescheduling of her foreign debt. (A beneficial result of these painful negotiations was the installation of

IMF representatives in the Central Bank who insisted that the Indonesian banking system should be put in order and they gave valuable advice and assistance in the difficult process of untangling the plethora of financial and exchange controls which had been introduced haphazardly over the previous ten years.)

It is worth considering whether the unofficial balance of payments was in surplus or in deficit during the Guided Economy. Though the Central Bank ran out of foreign reserves quite rapidly there is reason to believe that private holdings of foreign exchange grew considerably as people lost faith in the rupiah. For the upper echelons of society numbered Swiss bank accounts were also extremely useful for storing wealth outside the state run banking system.

By 1965 the government had lost all control of foreign exchange transactions, not only through embezzlement and corruption but also through policy actions. In 1963 the government had called in a team of American advisers to sort out the economic problems of the country and among other things they recommended a devaluation of the Rupiah and preferential treatment for imports and exports. The outcome was the '26th May Measures' which devalued the Rupiah and allowed exporters to retain 5% of their foreign earnings as foreign currency which they could use however they liked. In 1964 the system was changed again so that exporters were allowed to keep all foreign money that they received over and above the 'checkprice' value of their commodity, that is, the exporter could keep the difference between the price he received for his goods and the checkprice fixed by the government. These surplus earnings - estimated to be worth about 2% of export receipts - thus went into private hands outside the banking system.

More foreign exchange circumvented the banking system through exemptions and allowances granted to powerful political interests. The Department of Estates Production and the Department of Oil and Natural Gas retained substantial portions of their foreign exchange earnings through the political power of their leaders who claimed that their foreign exchange earnings were needed to finance the vital equipment and investment needs of their industries. It was officially unknown how much foreign currency was 'misaid' in this way by the Guiders of the Economy but it is known that the President had a 'special' budget under his personal control. From January 6th, 1961 the government stopped the publication of all financial statistics and this order was not revoked until December 28th, 1966, so that the suspect and corrupt dealings of those in power were shielded from public scrutiny. Revenue from smuggling, from the 'over-price' on legal exports, and from embezzlement thus fueled a foreign exchange market outside the official system. There was both an overseas drain and a domestic drain on the official reserves and therefore the Central Bank Balance of Payments Statistics eventually published in 1968 only tell part of the story.

After the fall of Sukarno the government embarked on the difficult task of bringing foreign exchange back under the control of the banking system. By persuasion, and a little arm-twisting while at the same time tactfully avoiding politically sensitive areas, foreign exchange dealings were brought back into the banking system. The most important single factor was the restoration of confidence in the banks. Once the banks began to offer more realistic rates of exchange and as the threat of spontaneous confiscation of deposits receded official foreign exchange business increased, though how much 'hot' money remained - and remains - out of sight is unknown.



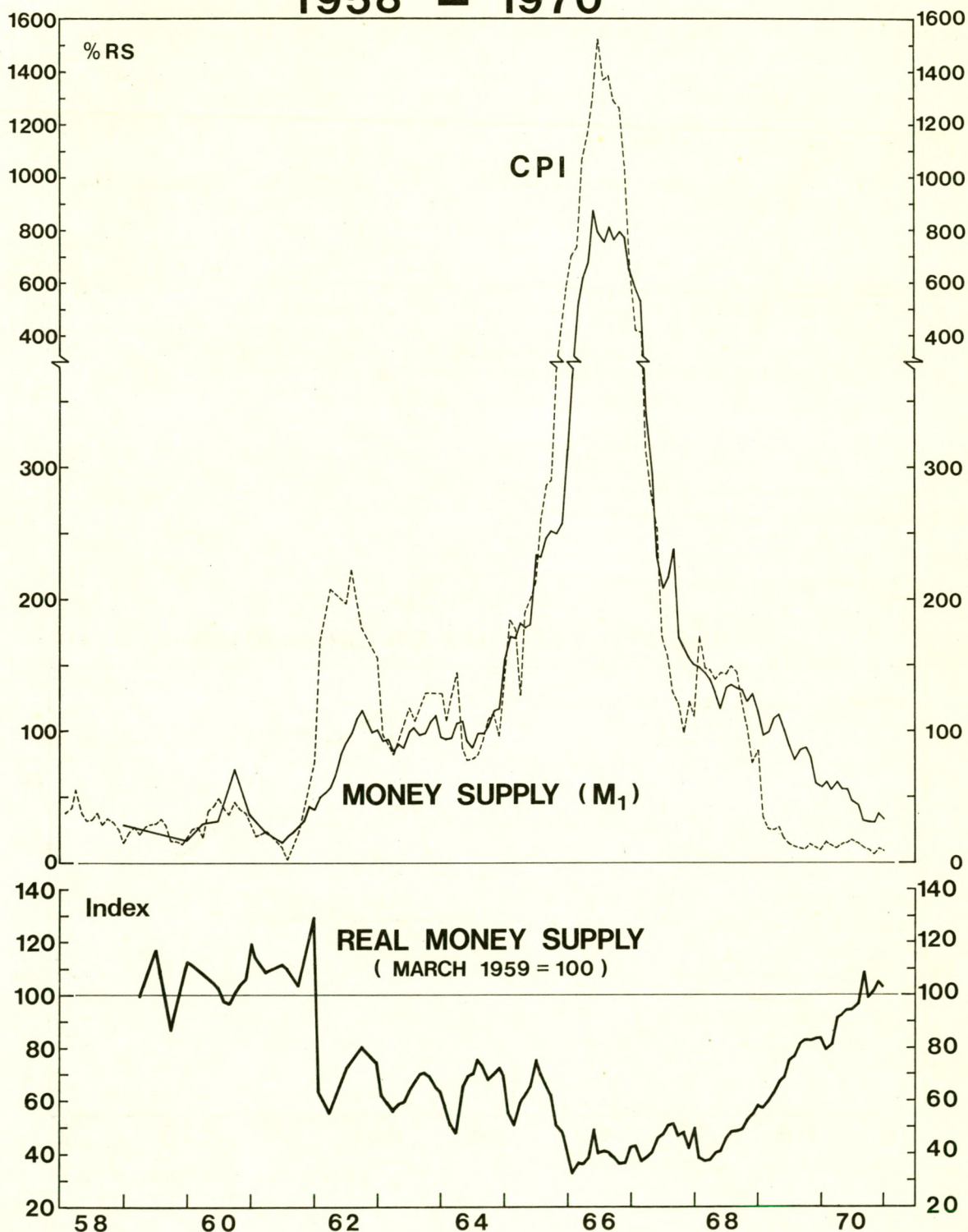
At the end of 1964 this bank note was worth about one US dollar on the blackmarket. The signature of the 'Gubernur' is that of the scandalous Jusuf Muda Dalam who became banking supremo in 1962, when he was made Governor of the Central Bank and Minister for Central Bank Affairs. In August 1966 he stood trial under three main charges of embezzling public funds, trafficking in import licences and the secret purchase of arms. It transpired that he had paid large sums in foreign currencies at his personal discretion to his collaborators, to the President and to himself. The press alleged that the Prime Minister Subandrio and Jusuf Muda Dalam had both salted away millions of US dollars overseas and that at the time of his arrest the Minister of Central Bank Affairs had embezzled 700 million New Rupiahs or about US\$10 million. It was also asserted that he kept 23 concubines and provided them with houses and cars at public expense. Dalam was found guilty and sentenced to death.

2) The Demand for Money, 1958-1970

An important consequence of inflation was the decline in the demand for real money balances. As the purchasing power of the rupiah dwindled its usefulness as a store of value was reduced and people avoided holding currency whenever possible. Traditionally the demand for money is analysed in relation to GNP but it is more convenient in this case to use the price level for several reasons. Firstly, prevailing GNP estimates for the period are very poor and are only available on an annual basis. Secondly, the deflator moves in any case very closely in line with the Jakarta cost of living index, so that the only difference between the price index and GNP figures is in changes in real GNP which in any case grew slowly in this period. The general movements in Marshall k and real money supply are therefore broadly similar.

In late 1961 there was a change in the relationship between money and prices. Before that time the money supply generally grew at least as rapidly and usually rather faster than prices corresponding to the long run trend towards monetisation of trade in rural areas and the expansion of the modern sector of the economy with its higher propensity to hold liquid assets. After 1961 this relationship reversed and generally prices rose rather faster than the money supply and it was not until after 1968 that the older secular pattern reestablished itself. Although inflation accelerated rapidly at the end of 1961 the money supply was by then growing more slowly, but this need not mean that the growth in money

MONEY AND PRICES IN INDONESIA 1958 – 1970

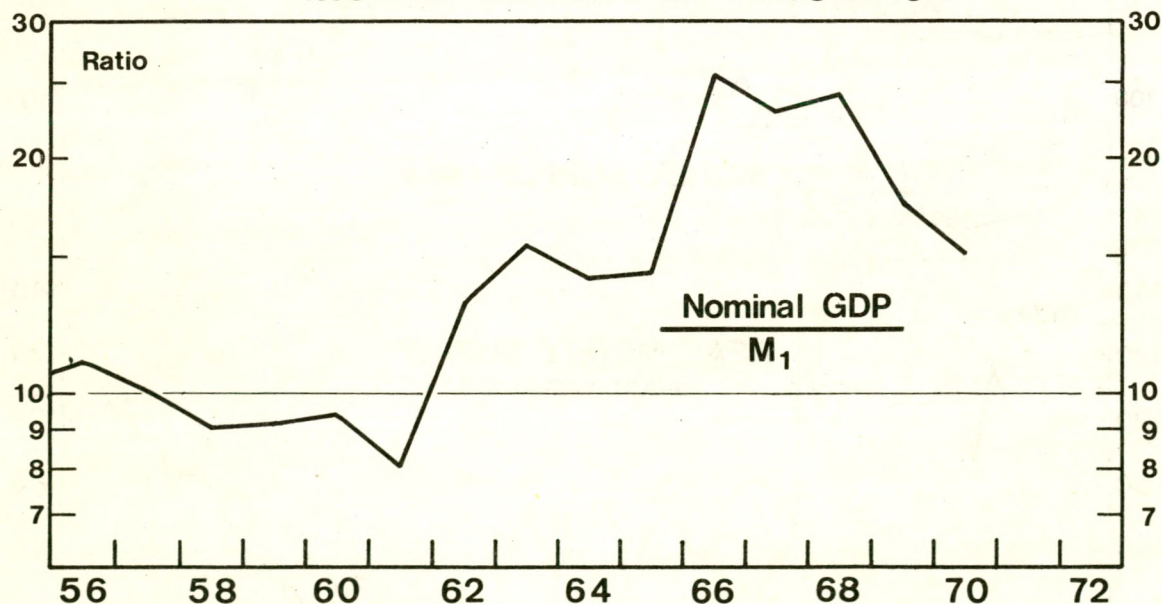


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supply was not the cause of the rise in inflation. This is clear from the behaviour of the real value of the money supply: late in 1961 there was a sharp increase in real money which was probably a major cause of the rocketing prices at that time. As people tried to reduce their real money balances to their desired level they bid up the prices of goods, but in so doing they increased the rate of inflation which further reduced the desired level of real money balances. The initial upward spike in real money supply was quickly transformed into a very deep trough and prices were pushed up to twice the level they would have been had the demand for real money remained stable.

The situation was somewhat different in 1965. The political and economic chaos caused great uncertainty for traders, the supply of goods was unreliable, and people feared shortages so the demand for goods increased. In addition the Government attempted to restore some semblance of balance to the budget by raising the prices of many utilities: Petrol was increased from the ludicrous price of Rp 4 per litre to Rp 1,000 per litre, railway fares were increased eight-fold, telephone charges six-fold along with the prices of many other services and products. These official price increases and the increased demand for goods pushed up the general price level with the result that real money balances declined sharply.

INDONESIA INCOME VELOCITY OF CIRCULATION



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Whereas in 1961 it appears that the monetary expansion preceded and provoked the price increases, in 1965 it was the price increases that prompted the monetary expansion. This is not to say that the price increases were independent of monetary inflation, it was just that the suppression of price rises in response to earlier monetary excesses came through as a sudden jump in prices which prompted yet more monetary growth.

As the authorities regained control of the money supply in late 1966 by instituting rigorous controls on the budget and the banking system, inflation came down rapidly even though the public were slow to restore their faith in the currency. Eventually as it became clear that the slowdown in inflation was not just a brief respite but reflected fundamental changes in the government regime, the demand for money began to grow again. Not only the eradication of inflation but also the recovery in business contributed to the demand, so that inflation dropped very sharply. Once confidence in the currency returned the public's ability to absorb money was voracious: in 1969 the money supply was still growing at around 60% per annum but consumer prices in Jakarta were increasing at a rate of only 12% per annum. The difference - 48% - went into restoring real money balances. The shift in attitude was so marked that the authorities became distinctly worried about the danger of squeezing the money supply too much and not providing sufficient funds to meet the demand for replenishing money balances.

The Banking System

Under the colonial administration the Indonesian banks had been mainly concerned with the financing of trade. There was no central bank as such before the war but the Bank of Java had performed some of the functions of a central bank; it was the government's banker and it issued the currency. In common with most countries in the Far East before the war the Indonesian banking system was dominated by foreign-owned banks whose business was confined to financing imports and exports with the result that there were almost no long-term loans.

The Bank Indonesia was formed from the Bank of Java on Independence and the Bank Indonesia Act of 1953 stipulated that the policy of the bank was to be decided by a Monetary Board chaired by the Minister of Finance. Since the Board consisted of Ministers of the Cabinet and the Governor of the Central Bank, it was from the start heavily influenced by the government. Over the years the grip of the government became stronger and from the point of view of policy the Bank and the government became virtually one and the same. In 1962 the posts of Minister of Central Bank Affairs and the Governor of Bank Indonesia were both filled by Jusuf Muda Dalam, the entire banking system was put under direct control of the cabinet, and the Monetary Board was rendered inoperative.

The banking system was brought under the direct control of the state only after several years of official intervention and obstructionism which had made private commercial banking difficult and unprofitable. In 1957 the Central Bank imposed liquidity requirements on the commercial banks and enforced a maximum rate of interest on bank advances. For some years the rate was a mere 6% compared with rates of inflation of over 20% per annum. In September 1959 the establishment of private commercial banks was prohibited and in the following year the Dutch banks were nationalised, their assets being taken over by one or other of the state banks. At the same time the State banks underwent a reorganisation which somewhat confused their relative tasks and made them administratively unwieldy.

Meanwhile more foreign banks came under pressure. The Bank of China and the Hong Kong and Shanghai Bank closed their doors in 1964. The Chartered Bank was seized by Bank Umum Negara (State General Bank) in the same year and all British enterprises were nationalised. From the end of 1964 until the downfall of Sukarno no foreign banks operated in Indonesia. Finally, in 1965 Presidential Decree Numbers 8 to 17 amalgamated all the

state banks into one colossal dinosaur called Bank Negara Indonesia. In effect the amalgamation was only skin deep, the seven Units of BNI continuing to operate as independent banks even though the task of altering the letterheads, rewriting noticeboards and repainting vehicles was zealously carried out.

The nationalisation and amalgamation of all the major banks in Indonesia placed almost the entire financial system under the control of the Minister of Central Bank Affairs, who was in many ways a latter day Tiberius. At his trial in 1966 the public were outraged to learn of Jusuf Muda Dalam's corruption, the enormous sums distributed to favourites and his debauchery with numerous concubines for whom he provided houses and cars. It is not surprising therefore that Central Bank policy seemed at times to be haphazard, vindictive, and ineffective.

Having severely discouraged all private banking activities the authorities recanted in 1964 and allowed private banks to be established where state banking facilities were inadequate. However, few institutions availed themselves of the opportunity because government regulations and rampant inflation hardly provided the ideal environment for such new enterprises to flourish. Of the hundred or so private banks that held out during the Guided Economy many were little more than cover operations for trading companies. To avoid taxes and the surrender of foreign earnings to the authorities, payments due to the companies would be 'deposited' with the private bank by the debtor and then 'loaned' to the creditor company. Such arrangements grossly inflated the figures for credit granted by these small banks.

Credit Policy

Following the monetary reforms of 1959 when a major portion of bank deposits were confiscated by the government and companies were therefore in urgent need of emergency credit from banks, it was realised that credit ceilings were impossible to enforce in such unstable and inflationary conditions. On October 15th, 1960 the Finance Minister replaced the system of credit ceilings with a reserve asset system: cash equal to a minimum of 10% of demand liabilities had to be deposited by the commercial banks with Bank Indonesia. Qualitative controls on credit were retained, for instance, state banks had to give at least 60% of their credit to the state sector, and at least 50% to the production sector and 20% to the export sector.

In practice, the banking system degenerated into a simple process of conveying funds from the Central Bank to the public. The banks did not borrow directly from the Central Bank; instead they presented importers' notes for rediscounting. Only in 1964 and 1965 did the banks fall back on direct borrowing to finance advances for 'government approved' purposes. The foreign exchange banks did however enjoy overdraft facilities with the Central Bank. As they were required to underwrite the debts of the smaller banks, in return Bank Indonesia underwrote the clearing debts of the foreign exchange banks.

Despite the enormous outflow of funds from the Central Bank the foreign exchange banks' holdings of cash and liquid assets fell below the legal minimum reserve requirements during the political upheavals of 1965. As public distrust of the monolithic state banking system mounted, the currency-to-deposit ratio of the public rose from two-to-one to three-to-one, further exacerbating the troubles of the banking system already caused by inflation.

To evade the utterly unrealistic regulatory 6% ceiling on bank loans enforced until 1960 the banks added substantial administration charges. Though the official ceiling rate was subsequently raised it remained woefully below the rate of inflation, and in August 1965 the administration charges were even given legal sanction when the state banks were told they could charge commission of up to 75% per month, making a complete mockery

of the official rates of 9%, 15% and 24% per annum for loans for 'essential' production, export production and other purposes respectively.

The Fall of Sukarno and Stabilisation, 1965-69

In May 1965 the communist party of Indonesia (PKI) celebrated its 45th anniversary with huge rallies, parades and celebrations involving thousands of people. President Sukarno made a rousing speech praising the revolutionary spirit of the PKI and strength of the Communist party seemed assured. But in July Sukarno fell ill, and it was believed his life was in danger. The PKI became alarmed at the prospect of a military takeover after Sukarno's death and some young PKI sympathisers in the army instigated a plot to eliminate the dreaded 'Council of Generals'. Sukarno did in fact recover, but on October 1st the young army officers in charge of commando units called at the houses of seven generals at two o'clock in the morning. The bodies of six of the generals were found dismembered at the bottom of a well four days later. Nasution - the seventh general - escaped. Public revulsion at the crime led to an anti-communist uprising and in the following months tens of thousands of communist sympathisers were murdered in a bloody purge throughout Java and Bali. Sukarno did nothing so the army refused to have anything to do with the new PKI regime and ignored Sukarno's orders. Sukarno reformed his cabinet in February 1966 but provoked student riots in protest at the retention of PKI sympathisers in the government. By March Sukarno had lost all effective power and the army forced him to sign over his powers to Suharto on March 11th. On March 12th the PKI was banned from Indonesia.

In the last months of Sukarno's reign his delusions of power and grandeur knew no bounds. In 1965 he withdrew from the United Nations to set up his own organisation: CONEFO the Council of New Emerging Forces - a United Nations for the Third World, and devoted enormous sums to the building of a stadium for his own version of the Olympic Games. Grand monuments and hotels were erected in Jakarta and at one time most of the railway rolling stock was tied up in transporting materials for these projects. In 1966 Sukarno was still talking about building 'the biggest mosque in the world' at Jakarta, and 'the biggest bridge in the world' from North Sumatra to West Irian. He once declared: "Many chicken-hearted souls with grocer's mentality count rupiahs and accuse me of being a spend-thrift I consider money spent for material symbols well spent."

The Deputy Premier in charge of Economic Affairs in the new regime on the 12th April laconically observed "Any person who entertains the idea that Indonesian society is experiencing a favourable economic situation is guilty of a lack of intensive study." The new government immediately clamped down on all government expenditure, all Sukarno's special projects were stopped, the civil service staff was reduced and subsidies on rice, petrol, sugar and public utilities were cut. The tax collection bureaucracy was reformed, the foreign exchange system was simplified, and an export bonus system was introduced to provide added incentives to exporters.

In May 1966 the Central Bank or Bank Negara Unit I as it had now become ordered State banks to stop all overdrafts and new investment credits. In October further instructions were given by the government. No credit was to be given for any imports except in explicitly designated special cases. No long term loans or overdrafts could be given and state enterprises and government agencies were to have no preferential treatment. Interest rates were raised from 6 to 9% per month and the banks' reserve asset requirements were raised.

These rigorous measures were immediately effective and, despite a poor rice harvest in 1967 which pushed up the price of rice in the last quarter of the year, inflation was brought down to 10% per year by the end of 1969. The budget was balanced in 1967, and in 1968 there was a small surplus - and achievement in stark contrast to the miserable record of the preceding seventeen years. It is worth noting in passing that one

of the contributions to bringing inflation under control was the removal of price controls; by reducing costly subsidies the government reduced its deficit and thereby stopped fueling monetary expansion, which was far more effective than any artificial fixing of prices of individual commodities.

What of the principles of the Guided Democracy? These were mercifully buried. Various foreign enterprises confiscated by Sukarno were returned to their owners, foreign banks were allowed into the country again and after a few years the 'Sole Bank' was dismembered and Bank Negara Indonesia Unit I put on its old clothes again as Bank Indonesia.

The Central Bank was divested of its commercial accretions and returned to being a Central Bank pure and simple. The State banks were rationalised and reorganised so that they worked at least partly in competition with each other to encourage efficiency and innovation. The Bureau of Statistics and the Central Bank began to publish information again perhaps symbolising the emergence of Indonesia from a long dark tunnel. Intellectuals exiled for many years returned to their homeland.

The remarkable recovery of Indonesia was a tremendous achievement but as a cautionary note it is worth quoting these words written in June 1966: "The old regime has left behind a legacy of moral disorder, of graft and corruption, of breakdown of law enforcement and decline in respect for the law - which can have few precedents in history. To repair this damage may be even harder than the damage to the nation's material capital."*

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BOOK REVIEW

'How Japan's Economy Grew So Fast, The Sources of Postwar Expansion', Edward F. Denison/William K. Chung, The Brookings Institution.

In the postwar period the Japanese economy grew at a phenomenal rate. Starting from an extremely low base (industrial output in 1949 was only two-fifths of the 1939-44 level) Real national income grew at an average annual rate of 9.17% between 1953 and 1971, compared with only 3.85% for the U.S. in the period 1948-69. What were the causes of Japan's tremendous growth?

The authors undertake the difficult task of estimating the quantitative contribution of each economic factor to the overall growth of GNP. Their first step is to estimate the growth of the inputs of the economy, which fall into the two broad categories of labour and capital. Throughout it is assumed that the contribution of each input to the generation of output is proportional to its share of overall income. Indexes of the quantities of labour, non-residential structures and equipment, inventories and land are constructed and then added together weighted according to their shares of national income. After these lengthy and meticulous estimations it turns out that the growth in the amounts of inputs accounts for less than half of the sixfold increase in real national income between 1952 and 1971. Of the total trend growth rate of 8.81% per annum, only 3.95 percentage points can be attributed to growth in the quantity of inputs, while 4.86 percentage points are to be explained by the more intangible factors, that is, the improved allocation of resources, economies of scale, advances in knowledge and other miscellaneous factors.

The main improvement in the allocation of resources was the shift of labour from low productivity jobs in agriculture and self employment to other sectors of the economy. From 1953 when 35.6% of all employed persons were engaged in agriculture, agricultural employment declined until by 1971 it was only 14.6% of the labour force. A similar decline in the percentage of workers in self employment or unpaid family work also took place. Adding on the tiny contribution of the reduction in trade barriers to the improved allocation of resources the authors estimate that the reallocation of resources contributed a total of 0.95 points to growth in the period considered. Economies of scale contributed a further 1.94 percentage points. The residual after all the other contributions to growth had been subtracted from the total growth rate is a substantial 1.97 percentage points or just under a quarter of the overall growth in GNP. This is attributed to advances in knowledge, improvements in the application of technology and other factors not already considered.

The overall conclusion then is that of an adjusted trend growth rate of 8.81% per annum between 1953 and 1971 1.85 percentage points were derived from changes in the labour force, 2.10 could be attributed to growth in the capital stock of the nation, 1.94 came from economies of scale and 1.97 from advances in knowledge and miscellaneous factors. The reallocation of resources added

another 0.95. In other words, no single factor predominated as a source of the economic growth of Japan.

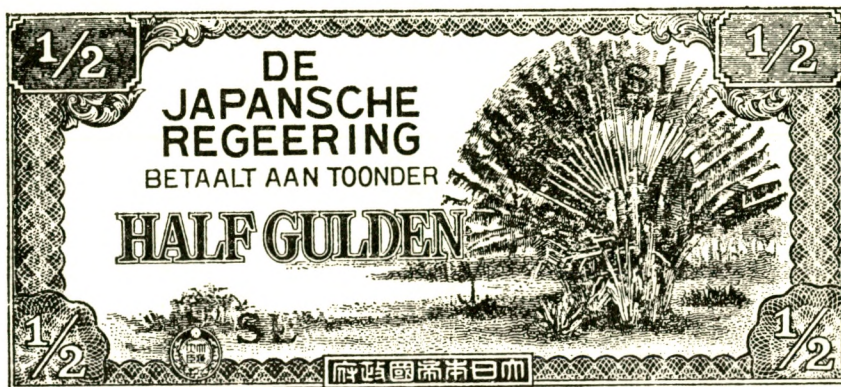
The authors compare their conclusion with the corresponding results for other countries and find that in four of the five categories enumerated above Japanese performance exceeded that in the United States, Canada, Belgium, Denmark, France, West Germany, Italy, Netherlands, Norway and the United Kingdom. Only West Germany and Italy gained more from the reallocation of resources. Only Canada gained as much from an important labour force. No other country benefitted so uniformly from all of the five main sources of growth, which explains why the Japanese growth rate was so much higher than in the other countries.

Can the growth rate be sustained? The authors separate each source of growth into two parts, one part which is sustainable and the other part which is transitory. By estimating the probable 'life' of the transitory components of growth the authors assess the implications of their work for the future growth prospects of the Japanese economy. Their conclusions are interesting. After the hectic growth of the sixties the Japanese economy can be expected to slow gradually in the seventies to a rate around 6.4% per annum by 1980. By 1990 the rate should be down to about 5.5% and after the turn of the century the long run sustainable growth rate of 3.24% should be reached. These results, based on economic data for the period 1953 to 1971, indicate that the Japanese economy would have experienced a reduced long-term rate of growth after 1974 regardless of any effects of the oil crisis. The authors make no attempt to analyse the effect - if any - of the oil crisis on the Japanese secular economic growth rate but rightly point out that a severe recession would increase the potential for high short-run rates of growth in the subsequent recovery.

Though this excellent work is thorough and careful in its approach to a very difficult problem, it would have gained from a more detailed discussion of the pros and cons of the methodology used. It would be useful to know where the authors think their estimates are most uncertain and where they have most confidence in the results. In particular a clear justification of their assumptions would be helpful. As the authors admit this book is about how Japan grew, not about why it grew. It is worth emphasising the point. On the one level, the growth in the economy can be attributed to a high rate of capital formation, an improvement in the age structure, education and skill of the labour force and the benefits of knowledge, economies of scale and other factors. On another level one can ask: why was there a high rate of capital formation; why were resources reallocated more efficiently; why did the Japanese gain so much from new technology and economies of scale?

The answers to these questions lie in the social and political environment in Japan, and the issues raised are rather different. How important were Japanese institutions and government policy? How much can be attributed to the renowned qualities of the Japanese people? These are the most interesting questions and they are also the most difficult to answer.

JAPANESE OCCUPATION CURRENCIES (1).



$\frac{1}{2}$ Gulden : Sumatra

During the Japanese Occupation of the Dutch East Indies (1942-45) three different types of notes circulated in the occupied territory.

- (1) Notes like the $\frac{1}{2}$ Gulden shown above were issued by the Japanese authorities in denominations from 1 cent up to 10 Gulden. Higher denominations were initially issued with serial numbers but subsequently bore only block letter overprints. In "SL" on the note above the S signifies Sumatra (in contrast, with 'B' for notes circulating in Burma, 'M' for Malaya, 'O' for Oceania and 'P' for the Philippines) while the L indicates the alphabetic ordering.
- (2) Reflecting the Japanese attempt to woo the local people against their former colonial masters the occupying forces also issued notes denominated in Roepiah (100 and 1000) instead of Dutch Gulden and designated 'Pemerintah Dai Nippon'.
- (3) Finally the Indonesian nationalist government issued Roepiah notes during the period of occupation replacing colonial issues which had featured Queen Wilhelmina.

All the wartime currencies suffered from gross over-issue. To pay even the lowest ranking Japanese soldiers it became impractical to count the notes and such payments were 'calculated' by means of a measuring stick placed against a pile of notes. At the end of the war the Dutch showed their disapproval of wartime independence movements by refusing to redeem Gulden notes headed 'De Japansche Regeering,' but only in the ratio thirty to one.



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MALAYSIA: Independent Monetary Policies.
- TAIWAN: The Problems of a Pegged Exchange Rate.
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China and the Silver Standard.

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KEY TO SYMBOLS USED IN THE CHARTS

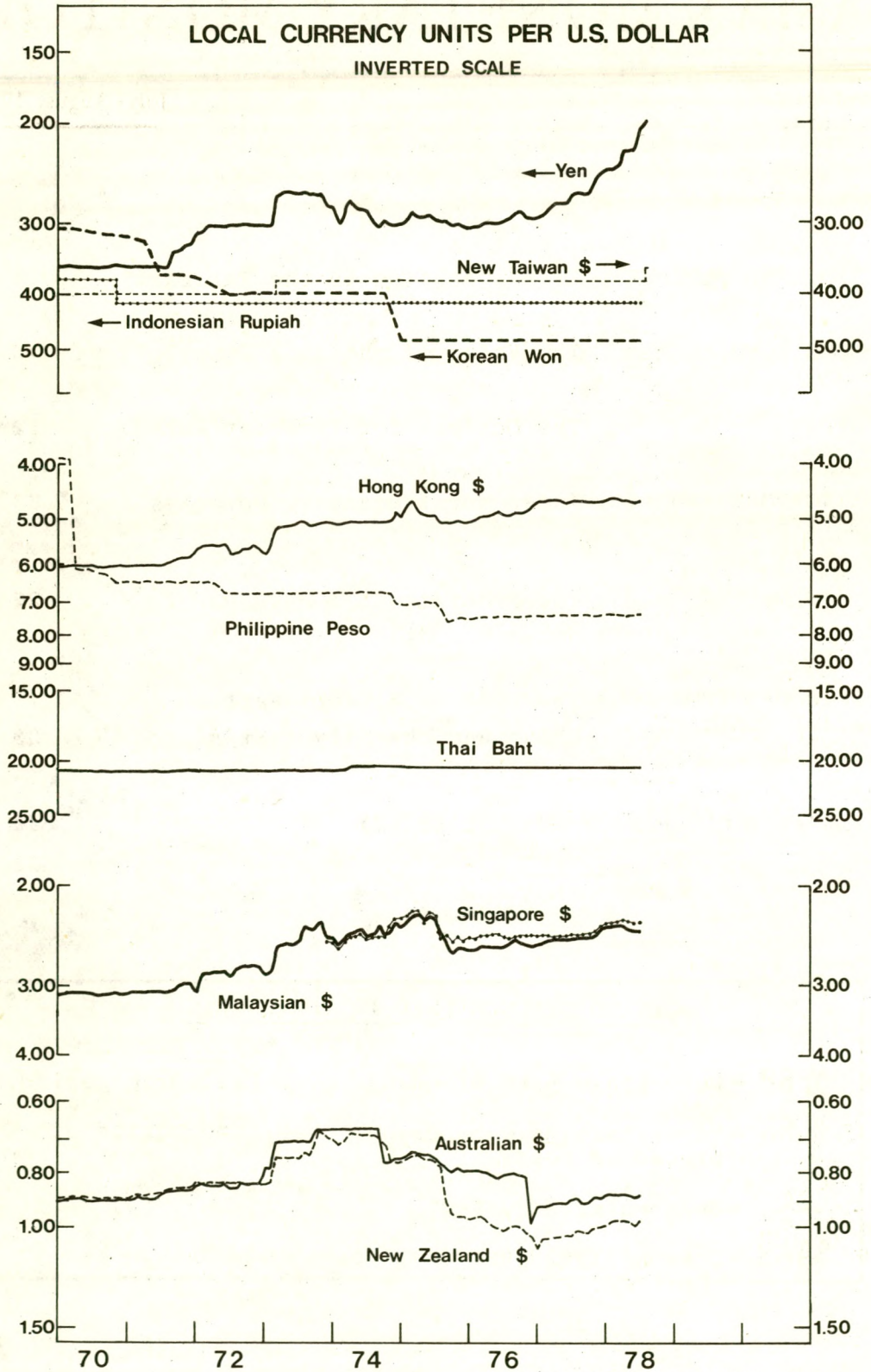
% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

CHART 1 EXCHANGE RATES IN THE FAR EAST



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REGIONAL SURVEY

EXCHANGE RATES IN THE FAR EAST

Since 1970 exchange rates in the Far East have followed one of two courses. Either they have been pegged at a rigid rate to the U.S. dollar, or they have been permitted to move in some more or less managed system. By the end of March 1978 every one of the five rigid rates shown in the chart opposite had been subject to an abrupt change, though in the case of the Thai Baht the change has been very small.* The Korean Won and the Philippine Peso, though they have been pegged to the dollar, have been devalued against the US dollar more than any of the nine other Far Eastern currencies shown in the chart. At the other extreme the floating Japanese yen had appreciated by nearly 50% between 1970 and the end of 1977.

Is there evidence to suggest that exchange rate policy can significantly affect exchange rates in the long run? Where rates are pegged short term movements are obviously more determined by political action than by market mechanisms, but might it not also be possible for governments to resist market forces for extended periods? In theory it might seem advantageous to the export industries of developing countries to maintain undervalued exchange rates. Taiwan, Korea, and the Philippines for example have elaborate systems of exchange controls which could be used in attempts to peg the exchange rates at very competitive levels. Have they in fact been able to do so?

The evidence given by the exchange rate experiences of the Pacific-rim countries suggests that they have not. First of all, the five 'pegged' currencies show no less change in their exchange rates than the six unpegged or 'managed' exchange rates. The standard deviations of the two groups of currencies are virtually the same, suggesting that the exchange rate policy adopted has had no effect on the long term trends in the rates. Secondly, the pegged currencies tend to be the weaker ones. The simple average of the appreciations of the six non-pegged currencies against the US dollar in the period was 22.3% while the average appreciation of the pegged rates was -17.1%. In other words, the non-pegged rates were substantially stronger than the US currency but the pegged rates have on average devalued against the US dollar. Does this mean that those currencies which have rigid exchange rates have been successful in keeping their exchange rates undervalued? Not necessarily. To answer this question price changes within countries as well as exchange rates must be considered.

If exchange rate changes are correlated with changes in export prices (see Chart 2) it is clear that there is a strong relationship between the two. Those countries which have experienced small increases in their export prices have tended to have stronger currencies than those which have had large increases in their export prices. For instance Japan has

* The five pegged currencies are the Indonesian Rupiah, the New Taiwan dollar, the Korean Won, the Philippine Peso and the Thai Baht.

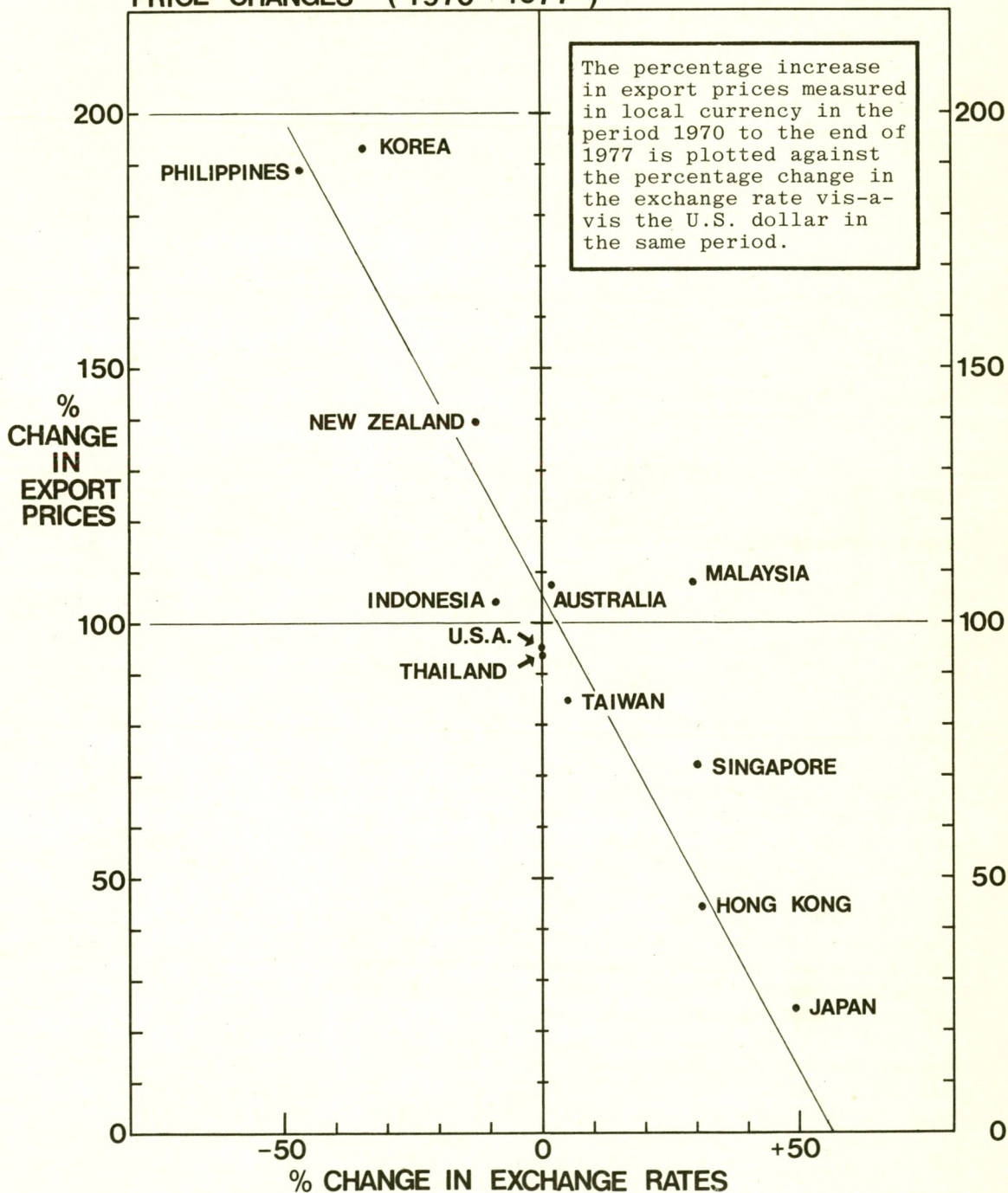
experienced rather low export price inflation since 1970 and the yen has been the strongest currency in the region, while the Philippines and Korea experienced the highest inflation in the region and the greatest devaluation of their currencies. In theory, leaving aside the imperfections in the price indices used, a 10% increase in export prices relative to US prices should be paralleled by a roughly equal percentage depreciation in the currency relative to the dollar in order to maintain the competitive position of the country concerned. Obviously, as the patterns of trade change and the composition of exports alters, a simple comparison of overall export prices can only provide a very rough guide to competitiveness; nevertheless, such an equiproportionate relationship between changes in export prices and changes in exchange rates would on average be expected to prevail.

If a currency is undervalued, the percentage devaluation should be rather higher than the percentage differential between inflation rates in that country and the USA. For instance to increase competitiveness a 50% rise in export prices relative to the US should be matched by a devaluation of more than 50%. This would be reflected in the country being below a 45° diagonal line running from the upper-left to the lower right on Chart 2. However, the chart does not show any such tendency. If anything it suggests the converse; the weaker currencies appear to be overvalued - that is above the diagonal. The devaluation of those currencies have been less than the relative changes in export prices, suggesting a deterioration in competitiveness. The stronger currencies exhibit the opposite tendency and appear to be undervalued; that is, they are above the diagonal and have experienced an improvement in their competitiveness. Even bearing in mind the limitation of such simple comparisons, the evidence seems to suggest that the pegged currencies have gained no competitiveness relative to the floating currencies and that in fact the contrary might be the case.

A final piece of evidence supporting the hypothesis that pegging currencies has had negligible effects on the long run changes in exchange rates is the fact that the five pegged rates do not lie out of line with the floating rates. The relationship between export prices and exchange rates appears to be more or less the same whether the exchange rates are tied to the US dollar or not. Using the data for all twelve countries shown in Chart 2, an estimate of the relationship between export prices and exchange rates shows that on average about half of the export price change relative to the USA is reflected in changes in the exchange rate. For instance, export prices in the Philippines have increased nearly 100% relative to US prices but the exchange rate has dropped by less than 50%. Such a relationship is only approximate and there are wide differences between countries; in particular the Malaysian export prices relative to US prices was only 13%.

Summary: An examination of export prices lends no support to the proposition that governments can affect the long run movements in currencies by pegging exchange rates. Neither does the evidence suggest that countries have been able to increase export competitiveness by deliberate undervaluation of their currencies.

CHART 2
THE RELATIONSHIP BETWEEN EXCHANGE RATES AND EXPORT
PRICE CHANGES (1970 - 1977)



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THE VALUE OF THE HONG KONG DOLLAR

The recent weakness of the Hongkong dollar highlights a poorly understood characteristic of the Hongkong monetary system. Though the Financial Secretary has in the past few years made references to the fact that the "automatic adjustment mechanism" no longer works in the same way as it used to under the old Currency Board system, we have not seen any official explicit statement of how the new adjustment mechanism operates.

The monetary system in Hong Kong is a modern transformation of the traditional colonial Currency Board. The key characteristic of the British Currency Board system was that the exchange rate was set at a fixed, immutable parity with sterling, so that any excess of inward remittances to the colony (a balance of payments surplus) would result in the creation of new local deposits or currency, which in turn would later lead to a more rapid growth of spending. As some of the additional spending would express itself in a raised demand for imports and hence an excess of outward remittances, the balance of payments surplus would be superseded by a deficit. Sales by the Currency Board of foreign currency (sterling) to meet the deficit and maintain the fixed exchange rate would necessitate the retirement of local currency or deposits, thus tending to contract the money supply which would put into effect a converse set of consequences. In this way balance of payments disequilibria were 'automatically adjusted'.

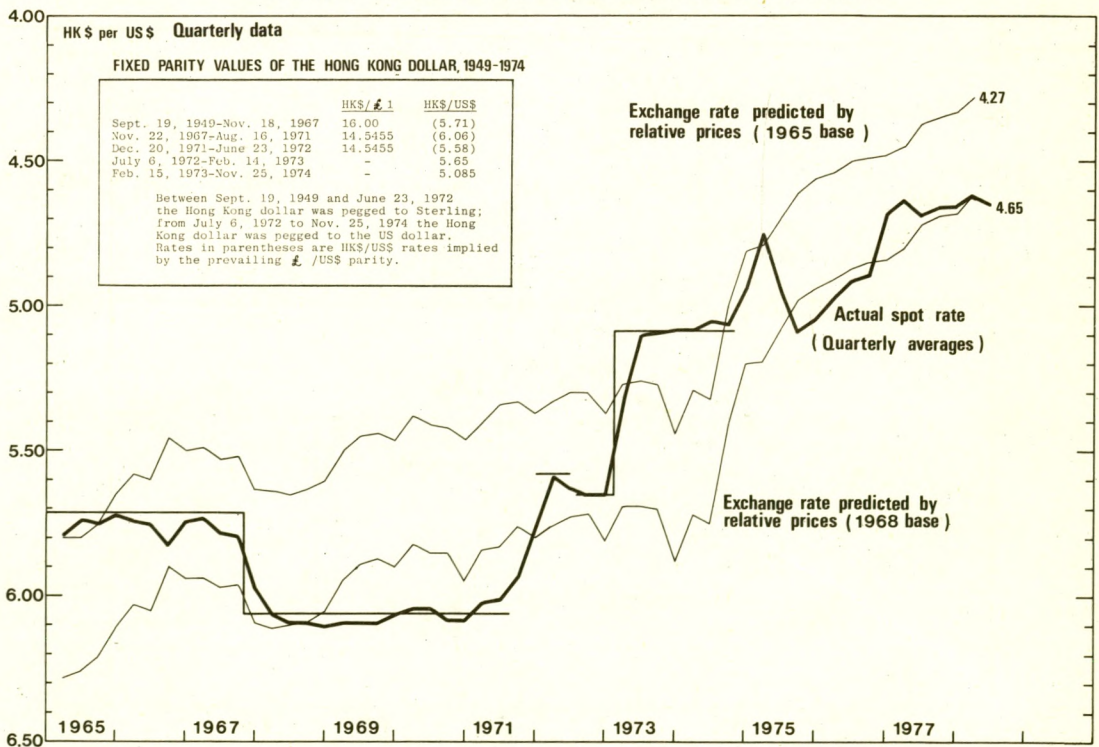
The modern transformation consists essentially of two modifications to the Currency Board system of automatic adjustment - one which is relatively unimportant from the standpoint of monetary analysis, and one which is central to the adjustment mechanism. The unimportant change is the alteration in the composition of assets held by the Exchange Fund to correspond to the Certificates of Indebtedness held by the note-issuing banks (which in turn correspond to the note-issue). In the silver standard era when private commercial banks issuing notes promised to redeem (or convert) their notes for a stated quantity of the precious metal, the quality and quantity of the 'backing' to the note issue was important. Since 1935 Hong Kong has been on a fiat system with no convertibility into silver, and the promise of the three issuers, the Hongkong and Shanghai Bank, the Mercantile Bank and the Chartered Bank, "to pay the bearer on demand at its office here xx dollars or the equivalent in the Currency of the Colony" no longer has the same meaning. The fact that foreign currency assets held by the Exchange Fund have shifted from being exclusively sterling to a mix of currencies including some local currency has not undermined public willingness to hold HK\$ banknotes or subsidiary coin.

The important change was the move, begun in July 1972, away from a fixed parity with sterling, initially to a fixed parity with the US dollar, and subsequently in November 1974 to a

floating exchange rate. As a result any net surplus of remittances into Hong Kong - for example, due to an increase in demand overseas - can now be accommodated by some combination of a change in the exchange rate and a change in the rate of monetary growth, leading in turn to a change in the domestic price level. Whatever the precise combination, the adjustment of the domestic price level and the exchange rate will be such as to keep Hong Kong's overall price structure in line with price trends of its trading partners. Chart 1, the basis for which was explained in AMM Vol. 1 No. 1, shows that movements of the HK\$ against the US\$ over the period since 1968 have roughly paralleled relative price movements in the USA vis-a-vis Hong Kong

However, since the present system does not ensure any particular combination of change in the exchange rate and the domestic price level, the system does have potentially very serious implications. Formerly prices in Hongkong dollar terms were determined by the combination of the fixed exchange rate and prices overseas, but today any price level in Hong Kong is compatible with any price level overseas through changes in the exchange rate. Thus high monetary growth rates and rapid inflation in the Hong Kong economy are as compatible with stable prices overseas as low rates of monetary growth and low inflation because the Hongkong dollar exchange rate can float downwards. The 'automatic adjustment mechanism' only ensures that Hongkong prices remain competitive; it does not ensure that the Hongkong dollar price level remains stable.

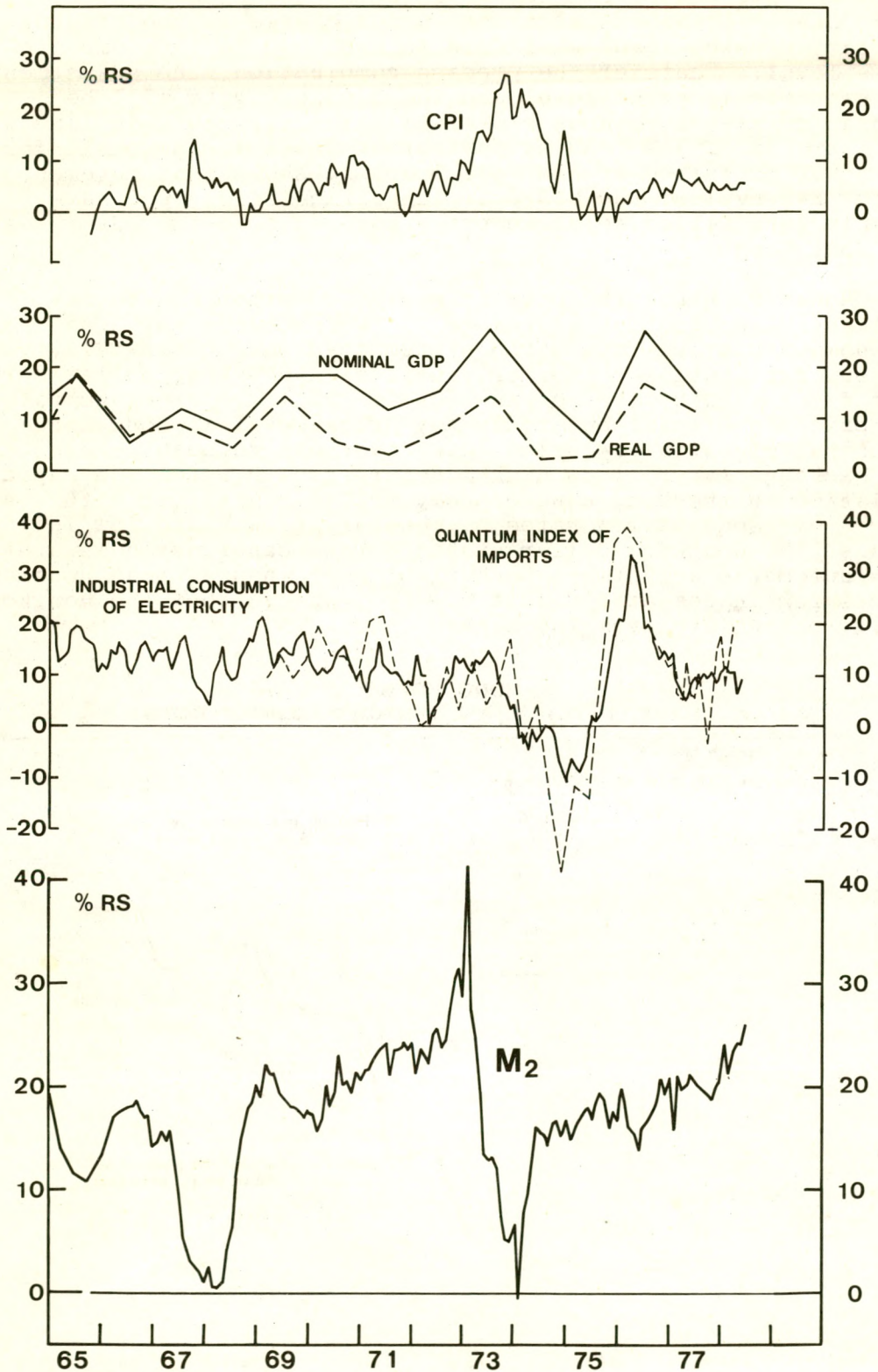
HONG KONG
CHART 1 : ACTUAL AND PREDICTED EXCHANGE RATES



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HONG KONG

CHART 2 : MONEY, OUTPUT INDICATORS, AND PRICES



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Under the old adjustment mechanism the situation we see today of continued rapid monetary growth and a booming economy combined with downward pressure on the Hongkong dollar exchange rate would have been unusual, to say the least. The weak balance of payments would have deflated the money supply, tightened credit, and dampened domestic demand. As it is, the latest statistics suggest that monetary expansion is accelerating rather than decelerating, property and share prices are soaring and interest rates remain low. The effective exchange rate of the Hongkong dollar has deteriorated by over 18% in the past eighteen months and recently the Hongkong dollar has been even weaker than the US dollar. The evidence therefore supports the theory that money supply and the balance of payments are independent.

What then determines monetary growth in Hong Kong and the exchange rate? Apparently not the government. The government has repeatedly stated that it will not intervene to affect the trend in exchange rate movements. Government officials have also said that it is inappropriate for Hong Kong to follow an independent monetary policy in pursuit of purely domestic objectives because of the very open nature of the Hongkong economy. This view is based on a misunderstanding of the role the government in society. Certainly the government may abstain from interfering with the cost/price structure of the economy, in that it may leave relative prices to be established in markets both overseas and in Hong Kong, but the government can and should ensure that the general price level remains stable. In other words, just as the government takes it upon itself to ensure law and order and provide the framework or infrastructure in which a free enterprise system can operate, it should also ensure that the medium of exchange - the currency - performs its role efficiently as a stable unit of value. Formerly the government attempted to ensure that this was the case by guaranteeing the exchange rate of the dollar initially against silver, later against sterling, and finally against the US dollar. As each of these standards has been abandoned the government has now relinquished any attempt to peg the price of the currency, but it has not switched to controlling the supply of money. To maintain the real value of the currency its quantity must be kept relatively scarce but with a floating exchange rate there appears to be no 'automatic mechanism' to ensure that this will be so.

Under the present monetary arrangements it is not clear that there are any constraints preventing the current rate of inflation from continuing or even accelerating unless the government decides either to control the price - i.e. the exchange rate - of the currency or the quantity of money in Hong Kong.

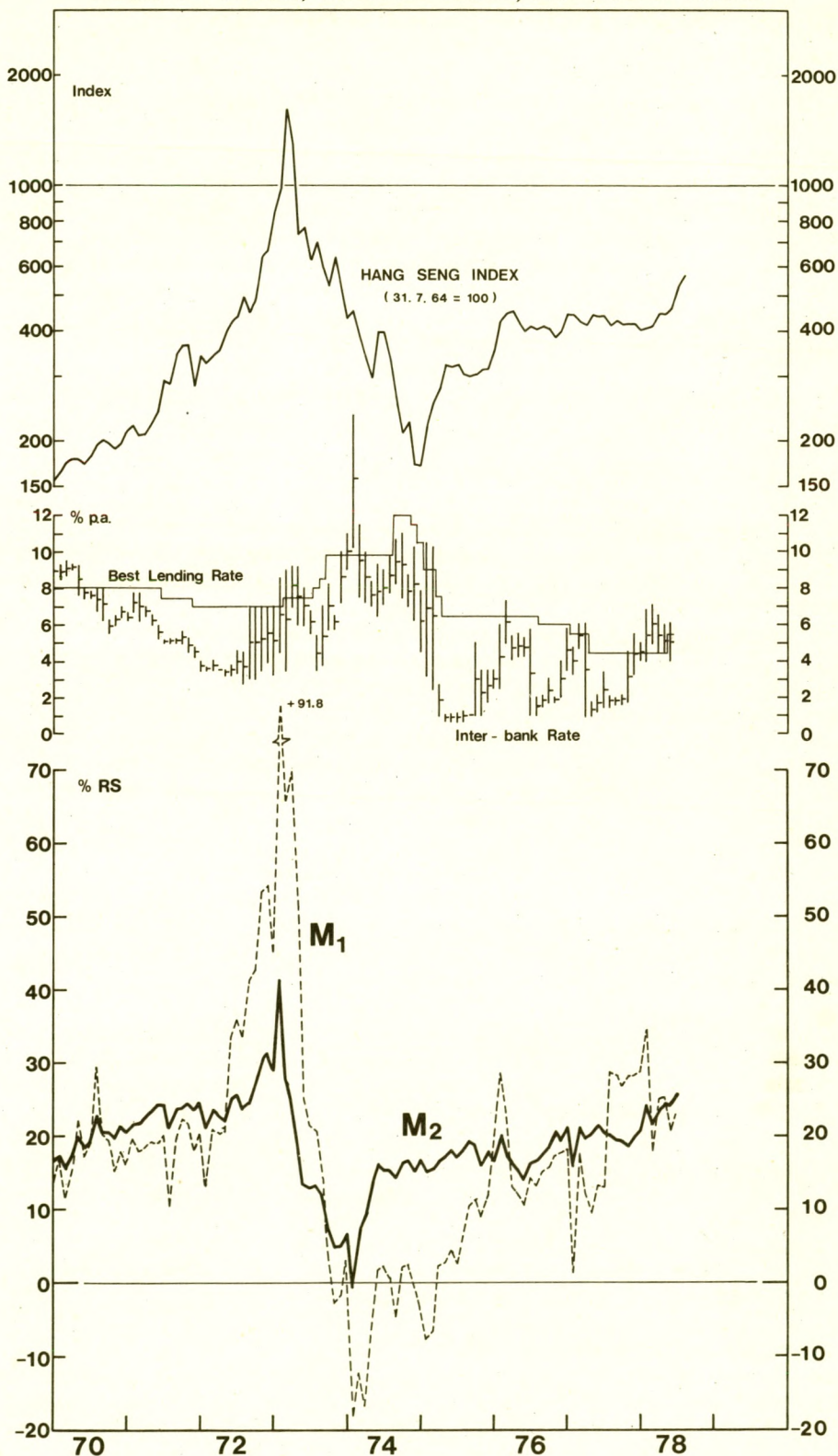
THE COST OF MAKING MONEY

The supply of money in a modern financial system should not be left to the free market because the creation of money is virtually costless. It is profitable to create Hongkong dollars until the 'price' of the currency equals the cost of production. When Hongkong dollars took the form of solid pieces of silver the cost of production, that is the mining and transportation of the silver and the cost of minting the coins, was substantial. When fractional reserve banking developed the expansion of bank deposits was constrained by the cost of acquiring reserves of silver coins to meet the eventuality of depositors wishing to withdraw cash.

The Currency Board then changed the 'backing' from silver to foreign currencies. The cost of creation of Hongkong dollars then represented the amount of real goods which had to be given in exchange for the foreign currency required for the issue of new cash. Today that link has been broken, and a given quantity of foreign currency can 'back' any number of Hongkong dollars by suitable changes in the exchange rate. Thus the amount of real resources that must be given up to 'create' a given number Hongkong dollars is indeterminate. If the banking system were a free market, the price (i.e. the purchasing power) of the currency would be competed down to the negligible marginal costs of administering bank deposits and printing the notes. Fortunately, the market is inefficient, the Exchange Banks operate as a cartel and banking is hedged about with gentlemen's agreements, conventions and regulations. Nevertheless market forces operate in the direction of over-expansion of the money supply with inflationary implications.

FORECAST: In the meantime the rapid monetary growth provides a strong stimulus to the stockmarket, points to accelerating inflation and rising interest rates in the months ahead and a continued weak currency. The longer term course of the Hongkong dollar is clouded with uncertainty. Unless the government sets up a system which explicitly guarantees the exchange rate or the purchasing power of the currency, confidence in the Hongkong dollar is built on shaky foundations. The authorities should either explain how the present system can maintain the value of the currency or else they should adopt a system which manifestly operates either to control the exchange rate or the amount of money in circulation.

HONG KONG
 CHART 3 : MONEY, INTEREST RATES, AND STOCK PRICES



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THE OUTLOOK FOR INTEREST RATES

Interest rates in Japan peaked in March 1974 and have been falling for almost four years. Along with the absolute decline in rates there has also been an increase in the flexibility of interest rates in the short term money markets and in the medium term government bond market. How is it that despite a large and increasing government budget deficit that rates have continued to fall? And why has there been a sudden spate of measures to free up interest rates in the money markets? The answers to both these puzzles are to be found first in a monetary analysis of interest rates, and second in a study of the logical consequences of the Bank of Japan's shift in policy away from pegging the exchange rate towards controlling the quantity of money.

The Keynesian Analysis of Interest Rates

Under the influence of Keynesian economics many students of money and banking were taught that there was a straightforward relationship between the level of interest rates and the quantity of money. If the quantity of money was increased (or grew more rapidly), it was said, interest rates would decline. If the quantity of money was decreased (or grew more slowly), interest rates were supposed to rise. At first sight this theory appears to be very attractive: in almost every business cycle it explains why there is a sharp rise in rates at the peak of the cycle when the central bank deliberately attempts to curtail monetary growth and calm down an overheated economy. The theory also seems to explain why interest rates fall in the early part of recovery when central banks are normally most aggressive, allowing monetary growth to accelerate in order to stimulate a stagnant economy. However, on closer examination the theory fails to explain the movement of interest rates during two very important interim phases of the business cycle.

Market interest rates, especially short-term rates, normally start to rise in the middle or late stages of business cycle expansions, but this is normally a time when monetary growth is still at a high level. For example from the fourth quarter of 1972 interest rates began to rise in Japan, but monetary growth did not become restrictive until the second or third quarter of 1973. On the other side interest rates began to fall in late 1974 and fell all through 1975; yet monetary growth remained highly restrictive and did not become expansionary until early 1976. How can the behaviour of interest rates in these intermediate phases be explained?

In addition the simple theory fails to explain the absolute level of interest rates. Between 1955 and 1965 the secondary market yield on medium term bonds in Japan averaged around 9.5%, and yet monetary growth was considerably faster, around 16%. Why didn't interest rates decline fairly consistently

over the whole period? Conversely, during the years 1922-28 market interest rates declined almost without interruption, which, according to the Keynesian theory of interest rates, ought to mean that monetary growth was accelerating throughout that 6-year period. Yet on the contrary, the quantity of money actually declined in 1922 and 1923, and rose by only 2 or 3 percent per year in the period 1924-28. How are these paradoxes to be explained?

The Monetary Analysis of Interest Rates

The basic problem with the Keynesian theory (or liquidity preference function) is that it is only concerned with changes in the supply of money, and overlooks changes in the demand for credit. It fails to explain what happens to interest rates when either the demand for credit rises or when the demand for credit falls. The monetary theory of interest rates is less simple, but more powerful in that it is more comprehensive, explaining a wider range of phenomena. In monetary analysis the level of market interest rates or the nominal rate is comprised of two elements, one component being the amount required to compensate lenders for the rate of inflation, and the remainder or real component being the result of the interaction of supply and demand at any one instant in time. In the early phase of a business upswing the market for funds is characterised by raised supply and lower demand resulting in lower interest rates; in the late phase of a business upswing demand rises relative to supply, and interest rates tend to rise. Similarly, the early phase of a business downturn is characterised by reduced supply and strong demand, resulting in higher market interest rates, while in the late phase of a downswing increased supply and slack demand result in falling interest rates.

How well does the monetary theory comply with actual experience? Also, if it provides a reasonably good explanation of the behaviour of past interest rates, what can be said about their future direction from present levels?

A. Nominal and Real Interest Rates

First, consider the absolute level of interest rates in relation to the inflation rate. During the period 1966-1972 inflation in Japan as judged by the average of consumer and wholesale prices was 3.5 per cent per year, while the market interest rate on bonds with one year to maturity was 7.51 per cent, giving a real return of just over 4 per cent on average. During the next two years, 1973 and 1974, the inflation rate soared so that real interest rates fell to yield a negative real rate of return. Parallel with the emergence of negative interest rates money balances as a proportion of GNP were being reduced (i.e. velocity was rising) as individuals and corporate businesses together attempted to reduce their holdings of such low-yielding assets and shift their portfolios towards higher earning assets. Another way of expressing this is to say that the Japanese as a whole experienced what economists call the "money illusion". By failing to predict the higher rates of

REAL INTEREST RATES IN JAPAN, 1966-78

	<u>Average Interest Rate</u>	<u>Average Price Change</u>	<u>Implied Real Interest Rate</u>
	(A)	(B)	(A)-(B)
1966	6.54	3.69	2.85
1967	7.56	2.89	4.67
1968	8.56	3.18	5.38
1969	8.58	3.63	4.95
1970	8.95	5.68	3.27
1971	6.92	2.72	4.20
1972	5.52	2.59	2.93
1966-72 Average	7.51	3.48	4.03
1973	9.29	13.83	- 4.54
1974	13.57	27.87	-14.30
1973-74 Average	11.43	20.85	- 9.42
1975	9.71	7.42	2.29
1976	7.84	7.20	0.64
1977	6.23	4.93	1.30
1978 (Jan-June)	5.44	1.04	4.40

All data are annual averages.

Interest Rates: Short term bond yield to 1976; From 1977
3-month repurchase rate.

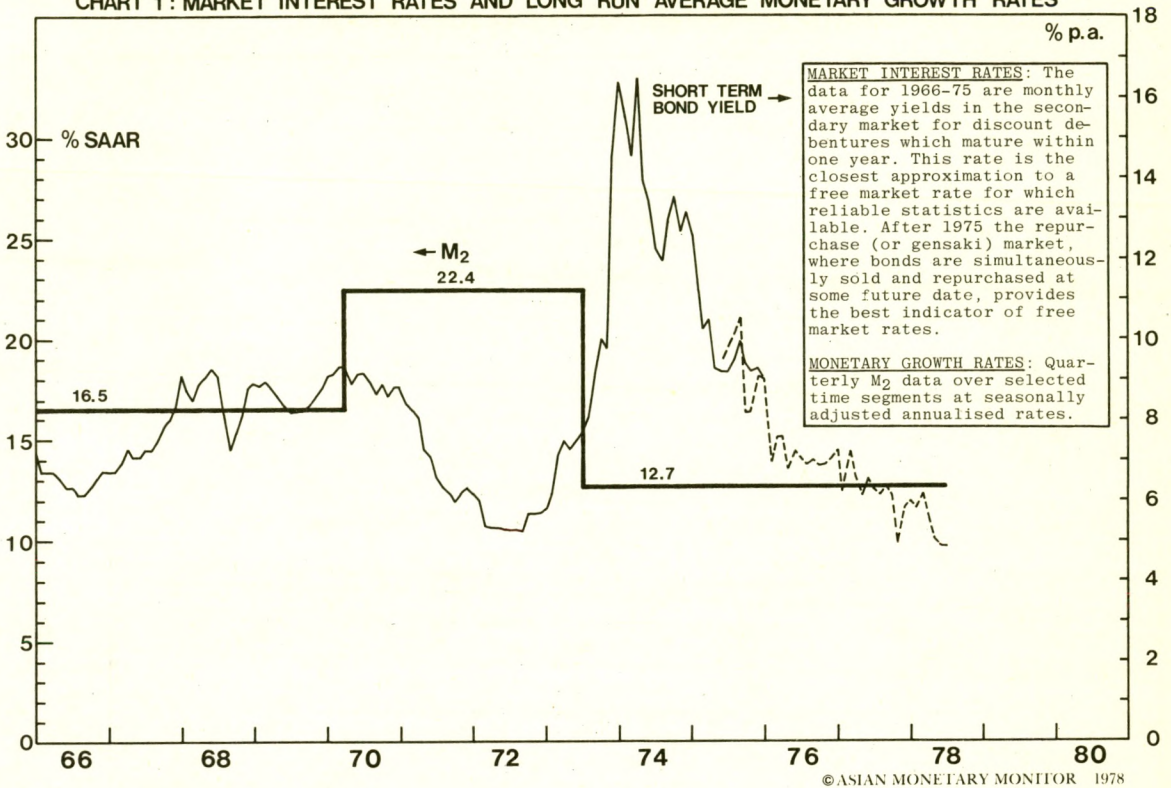
Average Price Changes: Average of consumer and wholesale prices.

inflation, lenders failed to protect themselves in advance against negative real interest rates, so that when the monetary squeeze came the need for liquidity was such that people were willing to pay as much as 14% per year in real terms for the flexibility it afforded them.

Since 1975 real interest rates have returned to positive levels as the overall inflation rate has declined. Adjusted for the prevailing low rate of inflation, therefore, the real returns which lenders in Japan are now obtaining are comparable with the real returns they obtained in the period 1966-72. From the standpoint of real returns, therefore, it would only be reasonable to expect a further decline in nominal or market interest rates if Japan's inflation rate were to fall below even its present level.

JAPAN

CHART 1: MARKET INTEREST RATES AND LONG RUN AVERAGE MONETARY GROWTH RATES



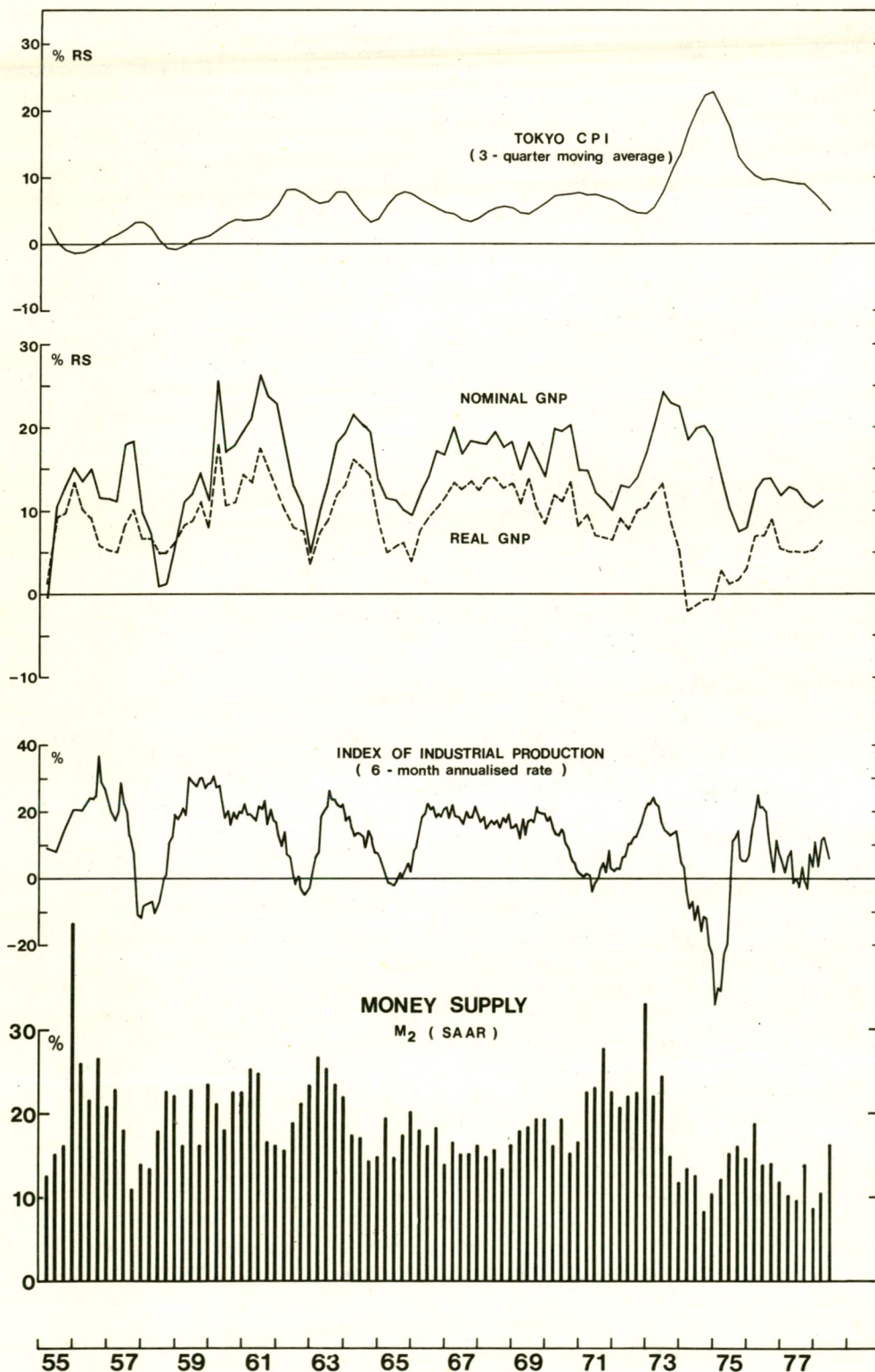
B. Monetary Growth and Interest Rates

Second, consider the relation between monetary growth rates over the period 1966-1978 and the changes in interest rates. For convenience Chart 1 shows the growth rates of M₂ over selected periods at seasonally adjusted annualised rates. The stepped line divides the whole period into three distinct periods, selected on the basis of the long run average rates of monetary growth.

Taking a broad overview of the period, the stepped line shows that between 1966 and 1971 monetary growth averaged 16.5 per cent per year, then rose to an average of 22.4 per cent over the period from mid-1970 to mid-1973, and has subsequently declined to an average of 12.7 per cent in the period since 1973. Initially, in 1966, interest rates declined, but as the level of economic activity picked up in 1967-68 (see Chart 2) interest rates rose. The peak in interest rates came in 1970 when more rapid monetary growth began to induce a decline in interest rates which continued until 1972. However, as higher levels of economic activity started to be recorded from mid-1972 interest rates began to rise, despite the fact that monetary growth remained at a high absolute level. The first effect of higher monetary growth was to lower interest rates; the second effect was to raise them. The reduction in monetary growth which started in late 1973 initially had the effect of raising interest rates very sharply to a peak of 16.5 per cent in March 1974. Subsequently as the economy went into recession

JAPAN

CHART 2 : MONEY, OUTPUT, AND PRICES



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and the demand for credit declined, interest rates fell sharply at first and more slowly later. In this case the first effect of slower monetary growth was to raise interest rates; the second effect was to lower them.

The clear implication of this analysis (in contrast to the analysis above which was concerned solely with inflation and interest rates) is that if monetary growth were now to accelerate and grow more rapidly for a sustained period, interest rates could fall further from their present levels. However, in order to predict a rise in interest rates the theory would require first an acceleration in monetary growth, and second a lagged rise in the demand for credit. Although the quantity of money has indeed been growing, it is still too early to argue that there has been any pronounced acceleration. Also, although the level of economic activity has been rising steadily since the start of this year, and the demand for credit could be on the upturn later this year - especially if the government expands its spending plans without raising additional revenue through taxes - neither businesses nor individuals show any signs of substantially stepping up their demands for credit. On a broad long-term view, therefore, there is no imminent danger of a sudden or sharp upturn in interest rates against the present background of reasonably steady monetary growth and modest demand for loans from the private sector.

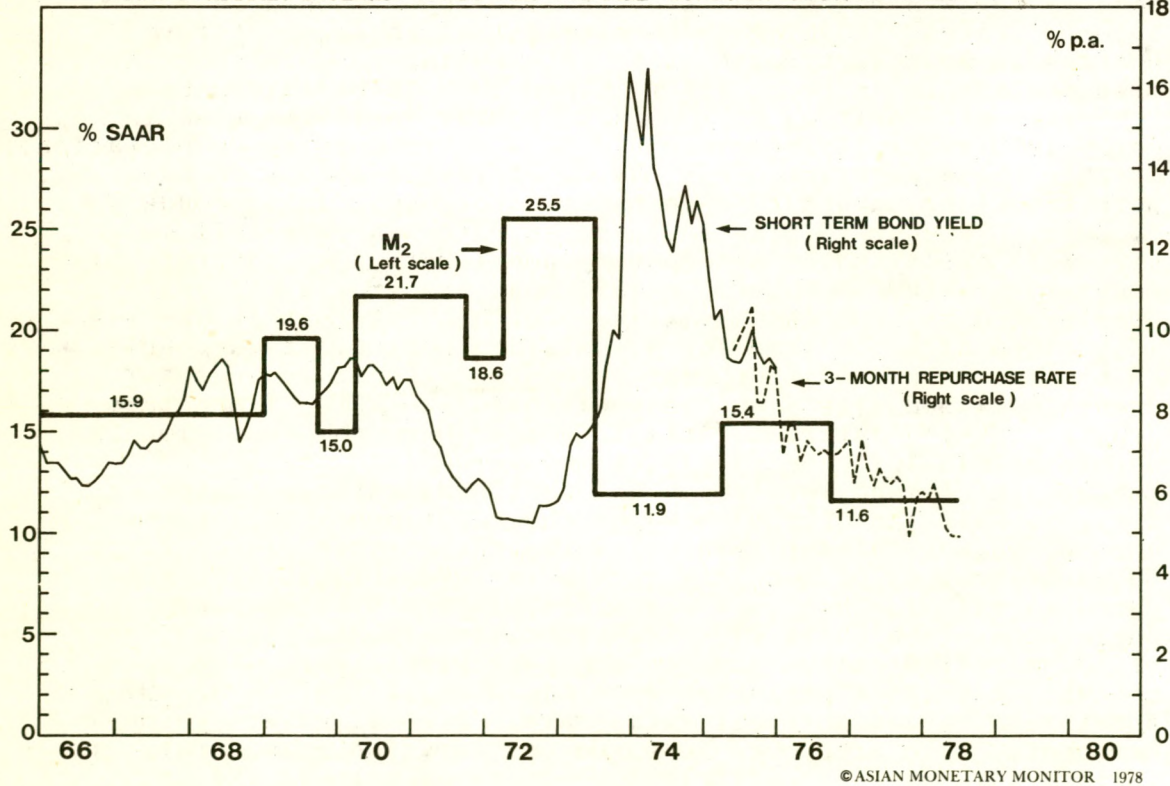
Chart 3 divides the long term pattern of monetary growth into shorter segments showing each discernible shift in monetary growth rates as a stepped line superimposed on interest rates. Looking in more detail at these short term changes in monetary growth it is interesting to note that the mild decline in interest rates in mid-1969 is explained by a temporary acceleration in monetary growth, while the rise in early 1970 is similarly explained by a corresponding deceleration. Neither the acceleration nor the deceleration appear to have persisted long enough to have had the corresponding secondary effects. The upward blip in interest rates in late 1971 is also well explained by a temporary deceleration in the rate of monetary growth. However, in 1973 monetary growth not only decelerated to less than half its previous rate but it was also maintained at a low rate for a sustained period. As a result there was sharp credit crunch: strong and rising demands for credit collided with a sudden decline in the rate of monetary growth, causing interest rates to soar. Once the recession had set in by mid-1974 the supply of money remained tight, but because the demand for credit had declined, interest rates fell, so that the second phase of the tight money policy was accompanied by falling interest rates rather than rising rates. The acceleration of monetary growth in 1975-76 initially caused rates to fall further, but was also followed by a recovery in the economy (see Chart 2). This time the secondary consequences of the more restrained rise in monetary growth were also more modest: instead of rising as they had done in 1967-68 or 1972, short term market interest rates merely stabilised at around 7 per cent. Also, the more measured deceleration in monetary growth in late 1976 was not sufficient to cause an actual rise in rates - probably the deceleration in monetary growth merely prevented a decline in interest rates which would otherwise have occurred. Indeed, the renewed weakness in the economy

associated with the slower monetary growth was again consistent with falling rates in 1977.

If this theoretical interpretation of developments in the pattern of interest rates over the past decade in Japan is correct, the prospects of further significant declines in interest rates in 1978 are surely remote. On the one hand the Bank of Japan is unlikely to engineer a falling price level, and therefore a fall in nominal interest rates due to a further decline in inflation must be considered unlikely. On the other hand it will now require either a distinct acceleration in monetary growth or some weakening in the economy to induce a further fall in interest rates from their present levels. But real GNP, or total real spending is rising, which suggests that the demand for credit is likely at some stage to match the growth in the quantity of money. Unless there is a significant shift in the components of GNP with less investment spending by business and less spending by government (and hence less borrowing), interest rates would appear to be near their trough for this cycle. Of course it is nevertheless possible that a sharp acceleration in monetary growth could occur resulting in lower interest rates at least temporarily, but the implications of the switch in Bank of Japan policy since 1974 suggest that this is most unlikely.

JAPAN

CHART 3 : MARKET INTEREST RATES AND AVERAGE MONETARY GROWTH RATES



Logical Implications of the Switch in Bank of Japan Policy

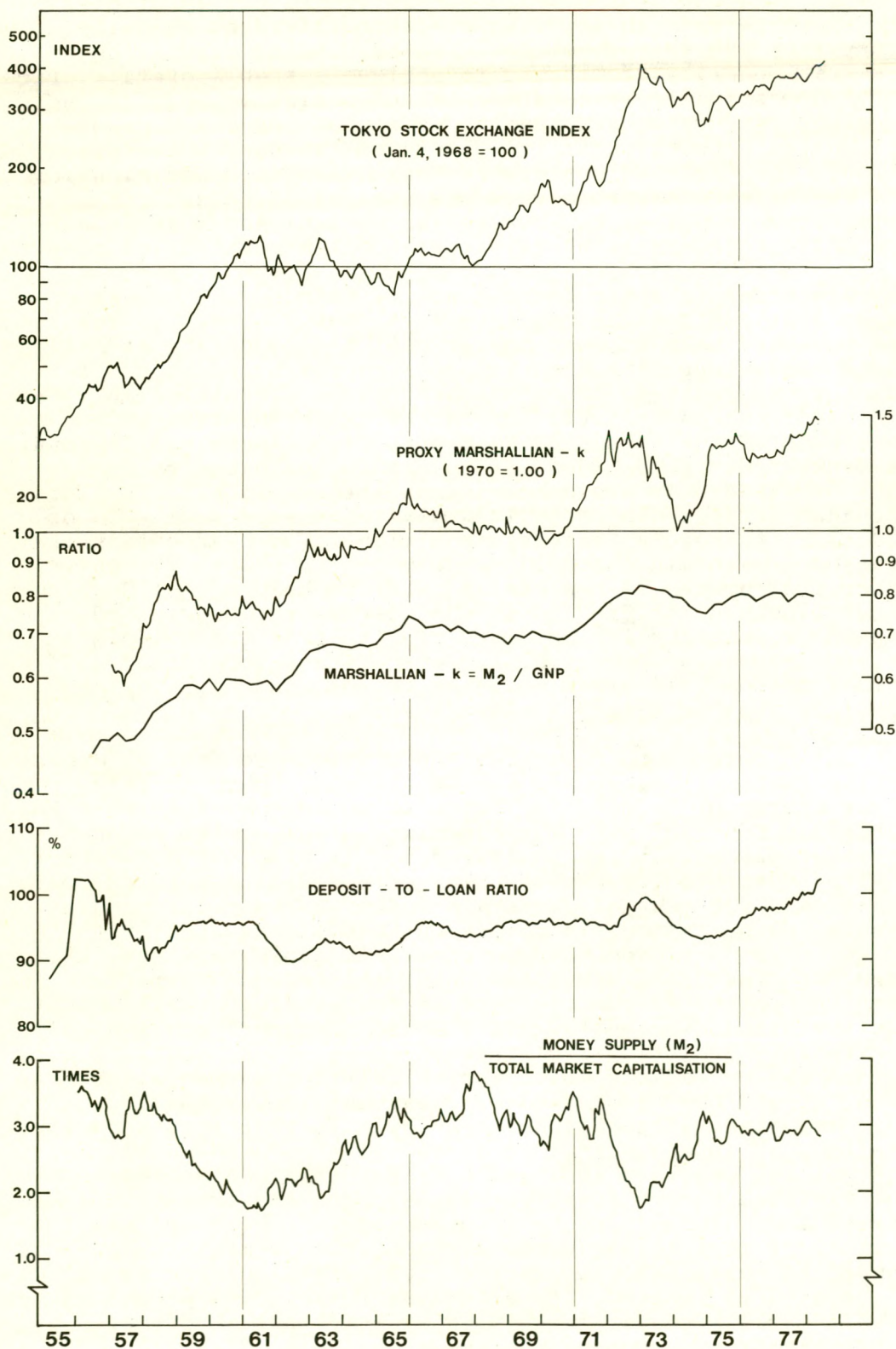
In 1974 the Bank of Japan moved from a policy of pegging the exchange rate to a policy of controlling the quantity of money (see AMM Vol. 1 No. 1). The purpose of regulating domestic monetary growth was to achieve a stable overall price level domestically in contrast to the policy of pegging the exchange rate which had had the effect of pegging Japanese price levels to those in the U.S.A. It is useful to follow through the implications of the Bank of Japan's decision for its own balance sheet to show how the recent changes in interest rate policy can be seen to be a direct consequence of the shift to controlling the growth of the quantity of money.

In order to control the quantity of money, the Bank of Japan must control the monetary base, but in order to regulate the monetary base it must buy or sell assets on a systematic basis consistent with ensuring steady growth in the broader monetary aggregates. Those assets can be classified into three different categories: (1) Foreign Exchange Reserves, (2) Government Securities and (3) Credit (i.e. loans and discounts) to Banks. Having decided not to peg the exchange rate, the Bank of Japan must avoid persistent intervention in the foreign exchange market, otherwise it will find itself adding to or reducing its foreign exchange position to such an extent that it cannot maintain control of the monetary base. The only other instruments it can utilise are its holdings of Government Securities and its Credits to the City Banks, but in order to expand or contract its holdings of either of these two sets of assets it must be prepared, to some extent, to operate at free market prices. In other words it cannot control both the quantity and the price of these assets.

With respect to Government Securities the Bank of Japan, acting as fiscal agent for the Government, moved in January to a new system of bidding for bonds to be sold by the Trust Fund Bureau in contrast with the old fixed price system which had operated throughout the postwar era. In June the Government invited open bidding at its sales of new medium-term (3-year) bonds, and the Bank of Japan also adopted a similar bidding system for operations in government bonds conducted at the end of June. Other moves towards a more flexible interest rate structure include liberalisation of the repurchase market, and some relaxation of the rigidity in the interbank call market and the bills discount market. These changes are all highly desirable, permitting arbitrageurs to act as an equilibrating force between markets which were highly compartmentalised and thus improve the allocation of financial resources. But the more important aspect of these changes is that they underline the Bank of Japan's willingness to shift to a new policy of controlling monetary aggregates rather than controlling either the exchange rate or interest rates. The conversion to free market mechanisms is by no means absolute: there are still a variety of rigidities in the Japanese credit markets and a number of politically sensitive areas where reforms are likely to be hard to achieve. Nevertheless these developments in the credit markets so far in 1978 provide further important confirmatory evidence of the basic change in direction of Bank of Japan policy since July 1974.

JAPAN

CHART 4 : THE STOCK MARKET AND 4 LIQUIDITY INDICATORS

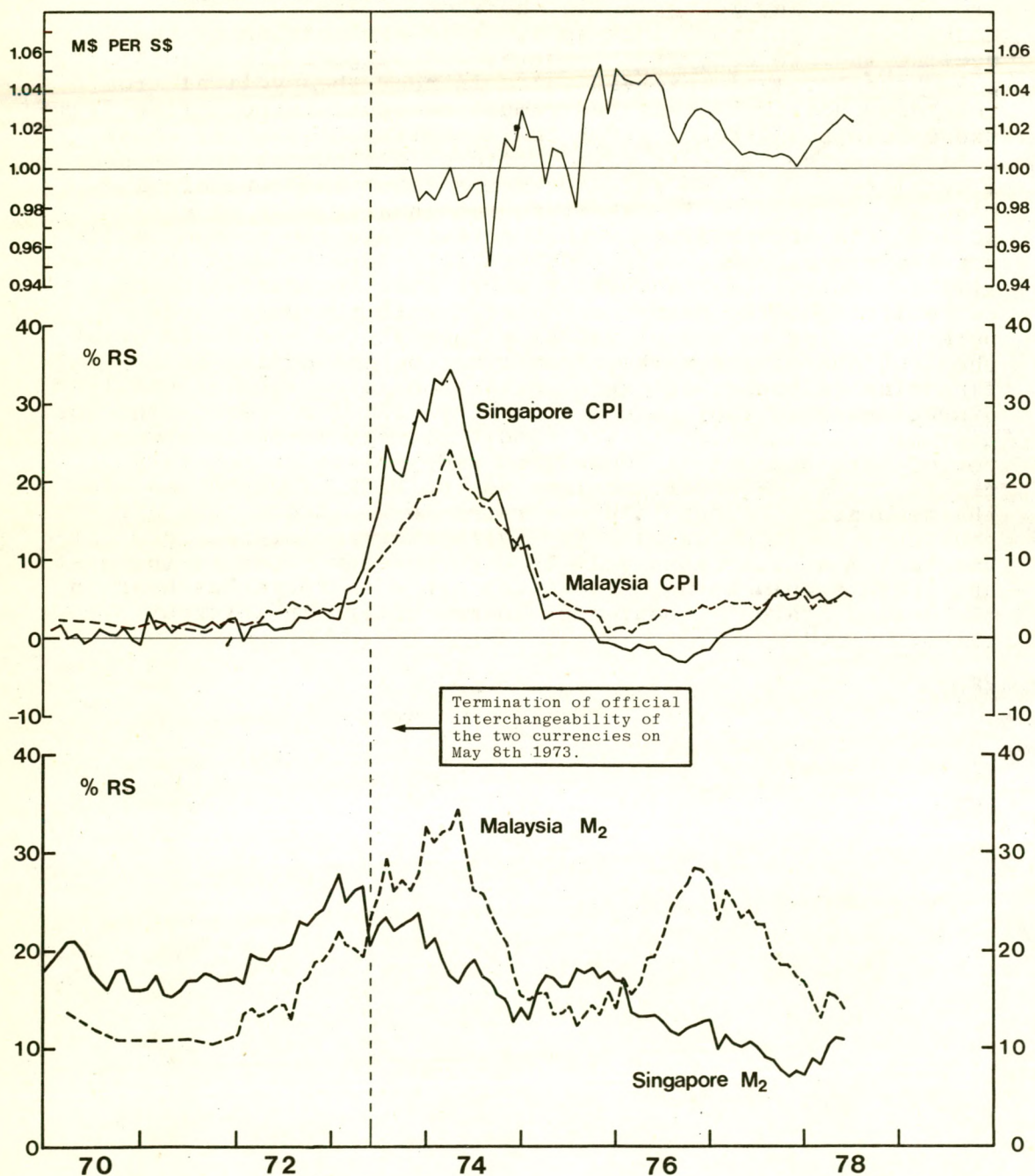


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FORECAST: Further declines in interest rates due either to a fall in the inflation rate or to an acceleration of monetary growth or to any weakening in the economy are unlikely. Monetary analysis provides an adequate explanation of the decline in interest rates to date, and suggests that looking ahead the level of interest rates is near the cyclical trough. This does not imply that there must necessarily be a rise from these levels. Indeed, given the stability of Bank of Japan policy and the evidence (from official actions in the area of liberalising interest rate movements) that the control of monetary aggregates is likely to remain a primary objective of policy, the probability is that activity in the economy will not rapidly become overheated, and therefore demands for credit will be restrained. Naturally there will be shifts in the composition of the demand for credit with the government perhaps having to bid up yields either at the short end or at the long end of the market from time to time during its financing calendar, but such shifts should be smaller and less disruptive than they have been in the past few years. The most disruptive influences in the credit markets in the postwar period have undoubtedly come from wide shifts in monetary growth rates. However, so long as the Bank of Japan resists the temptation to peg interest rates in the short term and continues to focus on monetary aggregates in future, interest rate movements in Japan will be more moderate than in the past and there should be no serious concern - as there has been in the United States - about a prolonged upturn in interest rates.

SINGAPORE AND MALAYSIA

CHART 1 : MONEY, PRICES, AND THE EXCHANGE RATE



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SINGAPORE AND MALAYSIA

INDEPENDENT MONETARY POLICIES

Since Singapore separated from the Federation of Malaysia in 1965, her pattern of trade has considerably altered and the relative importance of trade with Malaysia has declined. Today entrepot trade has been dwarfed by the import of raw materials to supply Singaporean industry and the exports of domestically manufactured goods. Along with the reduction in trade dependence Singapore's monetary system also became fully independent from Malaysia. Today there are no official ties between the Ringgit and the Singapore dollar; the Monetary Authority of Singapore (MAS) and the Bank Negara Malaysia follow different monetary policies; interest rates, prices and the balances of payments are following divergent paths. Can comparisons of monetary policy adequately explain the relative strength of the Singapore dollar and the contrasting experiences in the two economies since their separation?

Until 1973 Malaysia and Singapore maintained complete interchangeability of their currencies at a fixed exchange rate to the US dollar. In June of that year both currencies floated appreciating substantially against the US currency. Almost immediately monetary policies diverged. Money supply growth in Singapore began to slow down, - in 1973 M_2 grew only 20.4% compared with 26% in 1972 - while in contrast Malaysian M_2 accelerated from 20.1% to 32.7%. Since then the Malaysian money supply has been considerably more volatile than Singapore's reflecting the less concerted control by the Bank Negara compared with the strict supervision exercised by the MAS. Whereas prior to 1973 monetary expansion in Malaysia and Singapore moved roughly in parallel with Singaporean money supply growing just over 5% per annum faster (see Chart 1), after that year their roles have been reversed and the Singaporean money supply has on average grown very much more slowly. A slower rate of monetary expansion in Singapore suggests that the Singaporean currency should trade at a premium to the Ringgit, and - except during 1974 when the Singapore dollar traded at a small discount - this has been the case. Today the Singapore dollar is at a premium of about $2\frac{1}{2}\%$.

The initial weakness of the Singapore dollar after the float may be explained by examining relative price movements in the two countries. Between 1970 and 1973 consumer prices in Singapore increased twice as fast as in Malaysia so, on a purchasing power parity basis, it is likely that Singapore's relative competitive position had been deteriorating when the currencies were unpegged hence the initial relative weakness of the Singapore currency. Thereafter, the tighter monetary policy in Singapore kept inflation lower than in Malaysia. Singapore's competitive position steadily improved and the currency moved to a premium on the Ringgit. In fact Singapore has been so successful in controlling inflation that the consumer price index has risen less than 5% in the past two years, and wholesale prices have been stable for the past year.

Interest rates tell a similar story. After being higher in Singapore in the first year after floating reflecting the tighter monetary policy and the high rate of inflation, they later subsided as loan demand slackened and inflation was eliminated. Today the interest rate structure of Singapore is marginally lower than in Malaysia, which fact - though institutional differences may play a role - probably indicates that inflation expectations are rather lower in the former country.

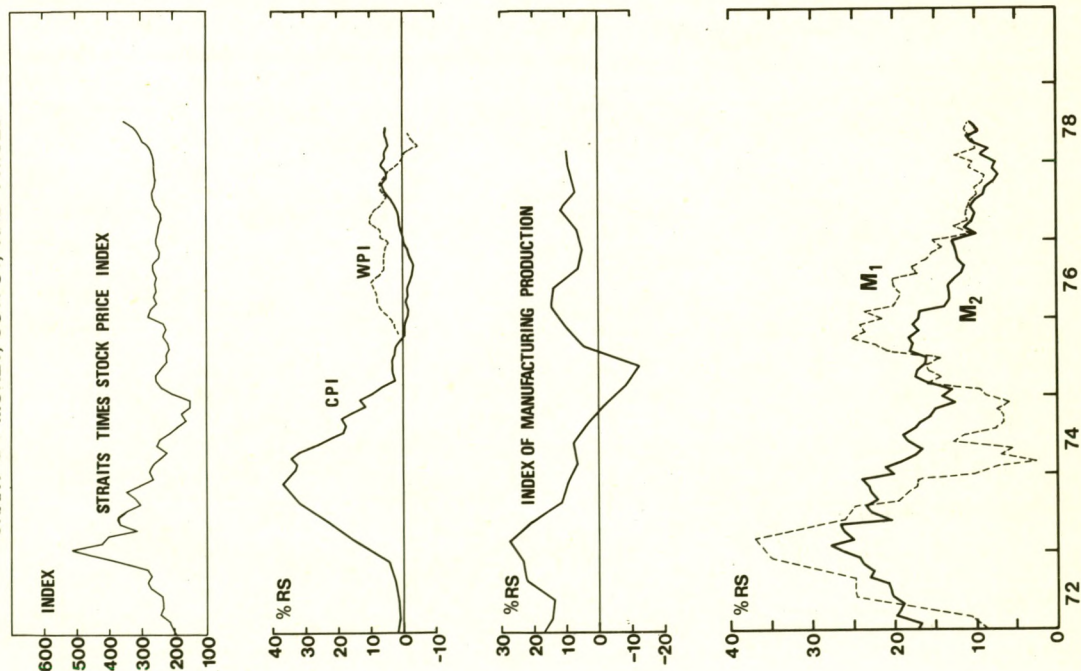
Incidentally it is worth noting that Singapore has had the stronger currency since the oil crisis despite the fact that resource-rich Malaysia has benefited substantially from oil and raw material exports. Singapore has been utterly dependent on raw material imports, and her oil import bill increased massively in 1974, yet, because of her more conservative monetary policy her currency has been strong.

In general, policy-makers have two alternatives with respect to monetary policy, either they can control the exchange rate but refrain from controlling the money supply or they can control the money supply and leave the exchange rate to find its own level. In practice most countries attempt to adopt a compromise policy of both managed floating and attempted monetary control. Though they may have limited success in the shorter run they are usually forced to abandon one or other of their objectives as balance of payments problems or inflation belie the incompatibilities of their policies.

Singapore and Malaysia provide contrasting examples of these policy choices. On the one hand Singapore appears to be exercising careful monetary control while loosening up foreign exchange regulations and allowing the currency to float. In recent months in particular the Singapore dollar has been allowed to float more freely. On the other hand Malaysia does not at present exercise effective monetary control so the money supply has waxed and waned with the trade cycle. The exchange rate however has been regulated 'relative to a basket of currencies', and the Ringgit 'float' is generally recognised to be highly managed. The Malaysian authorities rather than the MAS have probably been the major influence ensuring that the two currencies have not diverged too far. This alternative policy has not been trouble-free. The Bank Negara Malaysia is becoming increasingly concerned about the potentially inflationary effects of the easy money policy followed by the government and is now undertaking studies to examine whether a policy of greater monetary control is desirable. If they do decide to establish monetary targets they will be following Singapore's path but the effectiveness of such a policy will depend on allowing the Ringgit to float relatively freely.

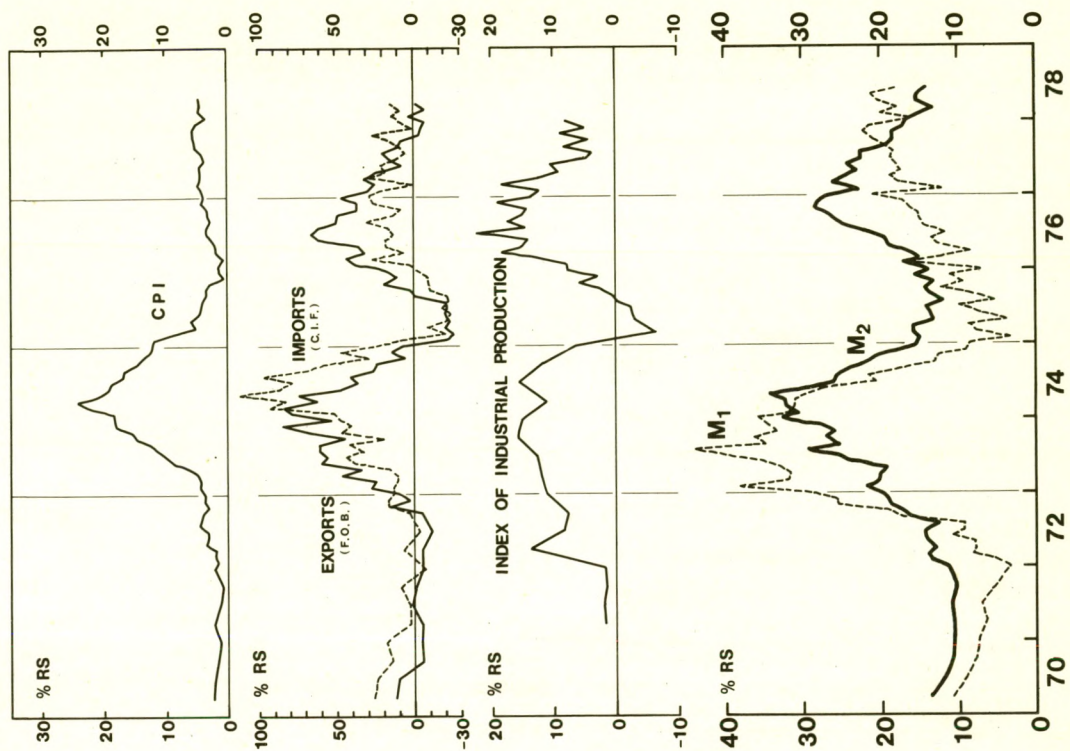
FORECAST: Wholesale prices will remain level in Singapore and consumer price inflation will be low in the current year though fluctuations in food prices may affect the price index in the short run. Interest rates will remain lower than in Malaysia and the Singapore dollar will continue to be a strong currency. The boom in the Singapore stockmarket largely reflects the rapid monetary expansion in Malaysia, rather than the more moderate policies followed in Singapore, but on the other hand the Singapore economic strategy is creating a more stable domestic environment and a potentially very strong currency.

SINGAPORE
CHART 2 : MONEY, OUTPUT, AND PRICES



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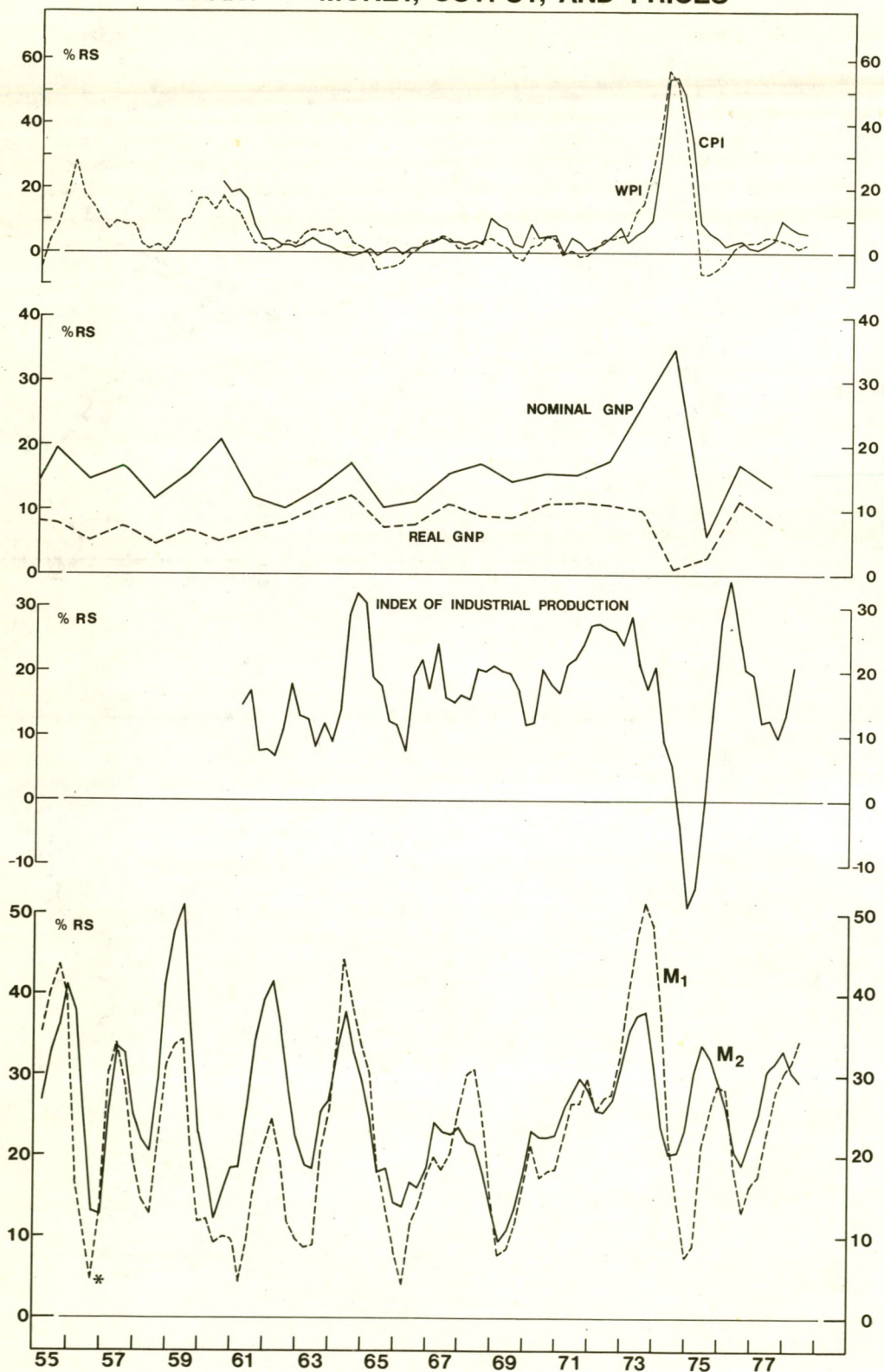
MALAYSIA
CHART 3 : MONEY, OUTPUT, EXTERNAL TRADE, AND PRICES



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TAIWAN

CHART 1 : MONEY, OUTPUT, AND PRICES



TAIWAN

THE PROBLEMS OF A PEGGED EXCHANGE RATE

On July 11, 1978 Taiwan revalued its currency, the New Taiwan dollar, by 5.26 per cent against the US dollar. The change in parity from NT\$38.00 to NT\$36.00 is symptomatic of a fundamental problem underlying Taiwan's monetary policy. On the one hand the authorities obviously wish to avoid a situation where the balance of payments surplus results in continuation of the recent highly expansionary trend of monetary growth, and yet on the other hand there is no assurance that the new exchange rate will actually provide the precise reduction in the balance of payments surplus necessary to bring about the appropriate monetary growth rate. Indeed there is no guarantee that there will be any reduction in the balance of payments surplus. Monetary growth could therefore continue to accelerate and inflation would almost certainly follow just as it did in 1959-60, or in 1973-74.

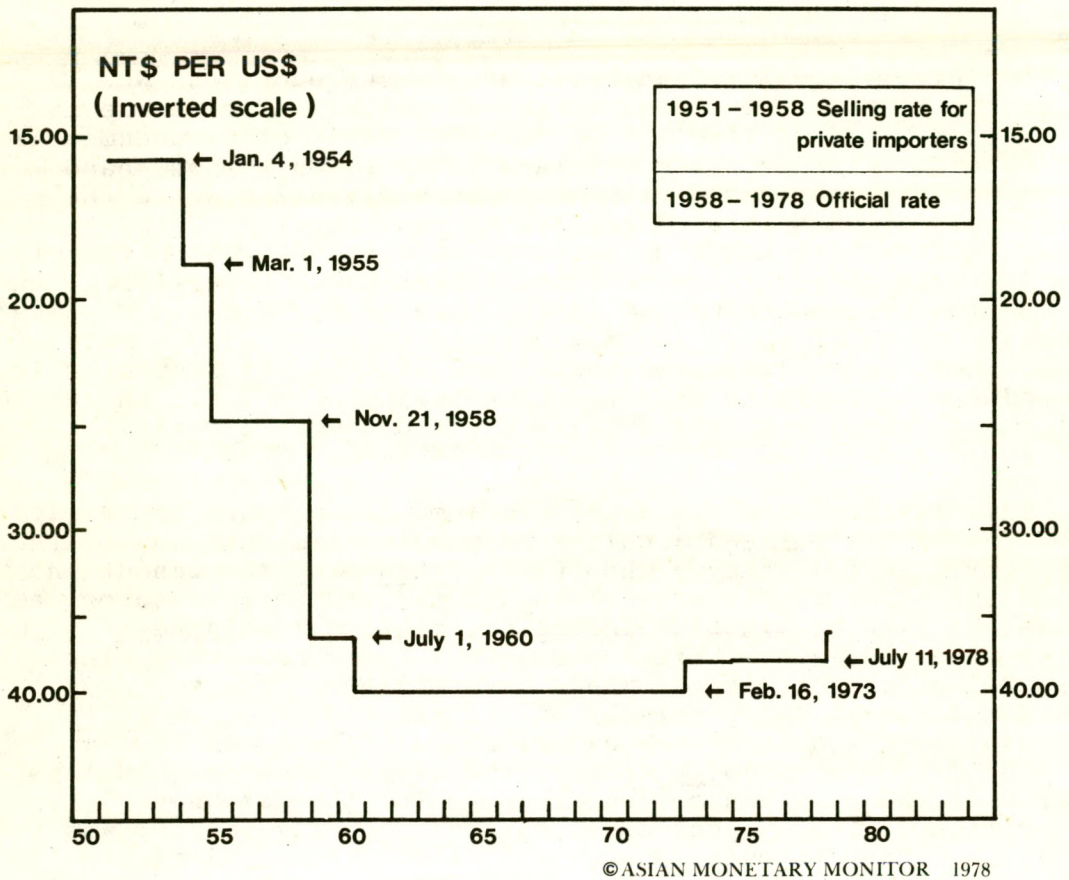
This is therefore not a new problem. Ever since the early 1950s Taiwan has pursued a policy of pegging its currency to the US dollar. To maintain an absolutely fixed rate throughout the period the money supply would have had to have been whatever was consistent with equilibrium in the international balance of payments. In the years 1955-78, Chart 1 shows that there have been wide fluctuations in monetary growth. Nevertheless, because these fluctuations were not precisely of the magnitude necessary to maintain the fixed rate, the experience of Taiwan has been a textbook illustration of the operation of the Bretton Woods system. Internally the system has tied the hands of the Taiwanese authorities to the exigencies of the balance of payments, and as a result they have repeatedly been forced to pursue policies which were inimical to domestic stability. Expansions and contractions of the domestic business cycle have largely been determined by the condition of the balance of payments. Externally the system resulted in exchange rates which were neither completely fixed nor completely stable; in the case of Taiwan the exchange rate has been a rigid one, but subject to sudden changes from time to time (see Chart 2 and box on p.28). As a further consequence of pegging the exchange rate in the attempt to maintain equilibrium or a small surplus there has also been a policy of encouraging exports and restricting certain kinds of imports by means of an extensive set of incentives and controls which are now extremely difficult to dismantle. Capital movements, too, are inhibited by a complex structure of foreign exchange controls.

Given the association between the pegged exchange rate and a highly destabilising pattern of monetary growth which has necessitated occasional but sharp changes in the foreign exchange rate, one may conclude that it would be desirable to implement a stable monetary policy with a floating exchange rate. The key question, then, is 'What constitutes an appropriate (i.e. stabilising) monetary growth policy?'

By implication we have defined 'stabilising' as a policy which reduces the amplitude of business cycle fluctuations. To eliminate

TAIWAN

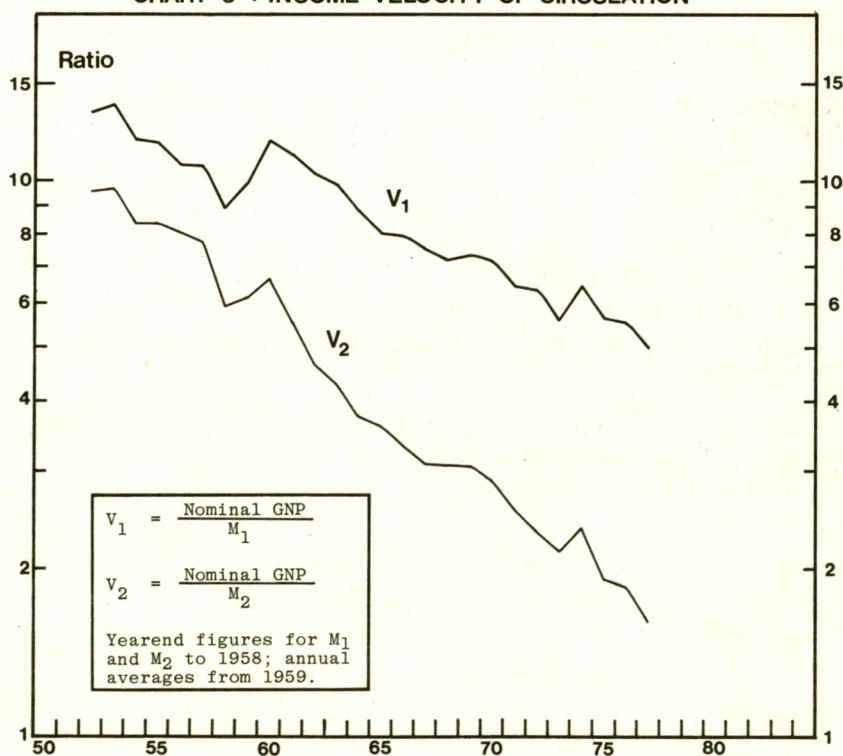
CHART 2 : OFFICIAL EXCHANGE RATE, 1951 - 78



Between 1951 and 1958 Taiwan operated a system of multiple exchange rates with preferential US dollar rates for exporters and government enterprises, and discriminatory rates for importers or for outward remittances. Following an exchange reform in 1958 and subsequent simplification of the exchange rate structure, there were two exchange rates up to September 29, 1963: an official rate and a certificate rate, both pegged. As from September 30, 1963 the certificate system was abolished and a unitary exchange rate was adopted with a buying rate of NT\$40.00 per U.S. dollar and a selling rate of NT\$40.10 per U.S. dollar. For the next ten years this rate was maintained until the formal devaluation of the U.S. dollar in February 1973 brought a change in buying and selling rates to NT\$37.90 and NT\$38.10. A further small adjustment to NT\$37.95 - 38.05 was implemented in February 1975, and this new rate was maintained until July 1978. The latest developments are a 5.26% upward revaluation of the NT\$ against the U.S. dollar to a central rate of NT\$36 per U.S. dollar, and an announcement by the Governor of the Central Bank of China, K.H. Yu, that the authorities are considering a revision of the present foreign exchange regulations to allow the establishment of a foreign exchange market.

cyclical fluctuations altogether is probably beyond the capability of any monetary policy, but to minimise fluctuations it is essential that monetary policy does not introduce independent disturbances into the business cycle. However, the experience of Taiwan (in Chart 1) and many other countries suggests that variations in the level of business activity and in the level of price inflation are closely associated with variations in the rate of growth of the quantity of money. But this relationship is not exact, either in terms of the time lag between changes in money and changes in output and prices, or in terms of the magnitude of the changes. Arithmetically any discrepancy between changes in money and changes in output and prices must be explained by changes in income velocity. For example, suppose there was a once-for-all increase in the quantity of money in Taiwan. If Taiwanese individuals and businessmen chose not to spend their additional money balances for precisely six months, there would be no effect on total output or aggregate prices until after that period, and income velocity during that period would have declined. Conversely, if they not only chose to spend the additional money balances but also ran down existing money balances, that would result in a higher level of spending and a higher level of income velocity. Put differently, in the first case each unit of money would be supporting a lower level of nominal income, and in the second each unit of money would be supporting a higher level of income. In the light of this variability in the relation between changes in money and changes in income it is clearly essential in formulating an appropriate monetary policy to have some understanding of the past behaviour of income velocity and to be able to predict its likely future direction.

TAIWAN
CHART 3 : INCOME VELOCITY OF CIRCULATION



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Chart 3 shows Taiwanese income velocity as the ratio of Nominal GNP in each year to the average of M_1 and M_2 in each year. Both lines have a very strong downward trend. The downward trend means that income per unit of money balances has declined, or that as income has risen, holdings of money balances have risen even faster. In fact the build-up of money balances in Taiwan relative to income is among the highest in the Asia Pacific region (see AMM Vol. 2 No. 3). We estimate that for every 1% increase in per capita real income in Taiwan per capita real money balances grow by 2.01% for M_1 and 2.73% for M_2 . In technical language, the elasticity of demand for per capita real money balances with respect to per capita real income is 2.01 for M_1 and 2.73 for M_2 . If we now assume that other factors affecting velocity (such as inflation and interest rates) do not change, one would expect annual declines in velocity of approximately 5 and 8 per cent per year respectively. From these estimates it is now possible to calculate an appropriate rate of monetary growth for Taiwan.

The relation between monetary growth ($\dot{M}$), nominal income growth ($\dot{Y}$), and the rate of change of income velocity ($\dot{V}$) can be expressed algebraically as follows:-

$$\dot{M} = \dot{Y} - \dot{V}$$

Nominal income growth ($\dot{Y}$) can be further divided into real income growth ($\dot{y}$) and the rate of change of prices ($\dot{P}$). As the set of prices must correspond to the concept of real income, the overall price level we are concerned with is the implicit GNP deflator, a price index which describes changes in the components of real GNP. The equation above can now be rewritten in the following form:

$$\dot{M} = \dot{y} + \dot{P} - \dot{V}$$

If appropriate monetary growth is defined as that rate of change which produces zero price inflation on average, we can set $\dot{P}=0$, and then ask what are the natural rates of change of real income ($\dot{y}$) and velocity ($\dot{V}$), and what rate of monetary growth ($\dot{M}$) do these imply? Our estimates, based on behaviour through the years 1952-77, are set out in tabular form below. For M_1 in Taiwan an appropriate rate would seem to be somewhere around 13% p.a. while for M_2 an appropriate rate would be in the neighbourhood of 17% p.a.

CALCULATION OF APPROPRIATE MONEY GROWTH RATE

[Appropriate rate of growth of money]		= [Rate of change of real income]		+ [Desired inflation rate]		- [Expected change of income velocity*]	
$\dot{M}_1$	=	$\dot{y}$	+	$\dot{P}$	-	$\dot{V}_1$	
	=	8.12	+	0	-	(-5.09)	
	=	13.21 per cent per year					
$\dot{M}_2$	=	$\dot{y}$	+	$\dot{P}$	-	$\dot{V}_2$	
	=	8.12	+	0	-	(-8.69)	
	=	16.81 per cent per year					

*NB This figure is not the same as the average historical value.

FORECAST: The revaluation of Taiwan's NT\$ highlights a fundamental issue facing the Taiwanese policy makers. At one extreme they could continue to peg the exchange rate, provided they completely refrained from attempting to control the quantity of money. At the other extreme they could control the quantity of money provided they allowed the price of their currency to be determined in a free market. (It would be desirable in either case to lift all controls on trade and capital movements because this would allocate resources to their most efficient uses and raise the level of welfare.) In continuing to peg their exchange rate, the authorities appear to have chosen the first alternative, but since they also show a desire to control the quantity of money by reducing its growth from the recent highly expansionary rates, one must be sceptical that the new pegged rate will be any more successful than the last. For the authorities cannot control both the quantity of money and its price in the foreign exchange market. In their efforts to do so they have in the past resorted to tariffs, quotas, foreign exchange controls and a variety of other devices. One result of these policies has certainly been to change the allocation of resources, but these policies have not prevented the exchange rate from changing, nor have they prevented inflation resulting from excess money growth.

Yet Taiwan is currently in the uneasy position of attempting to control both the quantity of NT\$ and its price in terms of foreign currency. One can therefore confidently predict that: either the authorities will be forced to shift the exchange rate or they will again lose control of the quantity of money.

Either course of action would surely be undesirable. As an alternative to the present policy the authorities could move towards controlling the quantity of NT\$ while allowing its price in terms of foreign currency to be determined in a free market. For non-inflationary growth our calculations suggest that a growth rate of around 12% per annum for M_1 and 15% per annum for M_2 would be appropriate. Anything much higher than this on a sustained basis would almost certainly lead to inflation. Anything much lower than this on a sustained basis would almost certainly lead to falling prices.

Not only would these suggested rates and the free exchange rate be desirable in promoting greater stability of the domestic business cycle, but it would then become clear that there was no need for the controls on trade and capital in order to achieve equilibrium in the balance of payments. Taiwan could then adopt a more liberal attitude toward the problems which have been such sensitive issues in its bilateral trade relations with the USA and Japan.

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THE FALL OF SILVER : Part 1 CHINA AND THE SILVER STANDARD

Until 1935 China provided an unusual example of an economy operating under a fluctuating exchange rate. Though the disruptive effects of fluctuating exchange rates were often emphasised by commentators of the time, just as they are by the press today, the fluctuating Chinese exchange rate had the beneficial effect of insulating China from the inflations and deflations which dominated economic activity in gold standard countries. This is the first of two articles which examine the economic consequences of the silver standard.

The World Drift To Gold

From the end of the 19th century till 1935 China was the only major country on the silver standard. One by one all the main trading nations had relinquished the white metal as a monetary standard and had joined the prosperous club of gold. Some like America had only adopted the gold standard after considerable political debate, others such as India were forced onto gold by their colonial masters, yet by the outbreak of the First World War gold was the trading currency of the world.

In Greek times gold had been relatively unimportant. Most trade had been conducted in silver and the value of silver in circulation had been far greater than the value of gold. In the East silver remained the primary medium of payment right up until the twentieth century - Persia, India and China were among the last countries to abandon the silver standard - but in the West silver gradually gave way to gold. The vast amount of gold discovered in the new world was minted and entered into circulation in Europe side by side with silver coinage, and eventually the form of monetary system established in Europe was christened 'the bimetallic standard'. The mints of Europe sought to establish a fixed ratio (i.e. peg the price) between the values of their large denomination gold coinage and their small denomination silver coinage.

In the latter half of the nineteenth century bimetallism gave way to the gold standard pure and simple. Silver coins remained in circulation but at fixed fiat values greater than their bullion values. Silver coinage became token coinage only. First Britain and then in the 1870s most European countries abandoned or reduced their monetary use of silver, reducing the need for silver for coinage and for bullion reserves. At a conference in Paris in 1867 the leading industrial countries of Europe decided that thereafter specie payments would be in gold alone. In 1871 Germany went on the gold standard. In 1873 the U.S., Denmark, Sweden and Norway began to adopt the gold standard, Belgium stopped using silver to mint 5-Franc pieces and France prohibited the free coinage of silver 5-Franc pieces. The following year the 'Latin Monetary Union' of France, Italy, Belgium and Switzerland collectively agreed to limit the minting of silver coinage. In 1875 Holland and the Dutch settlements stopped minting silver currency and in 1876

Finland went onto Gold. By 1880 most of Europe was effectively on the gold standard.

The consequences of the move to gold were profound for those countries which remained on the silver standard. The 'Economist' writing in 1876 clearly pointed out the effect of the abandonment of bimetallism:

"The cardinal present novelty is that silver and gold in relation to one another, are simply commodities. Until now, they have not been so. A very great part of the world adhered to the bimetallic system which made both gold and silver legal tender and which established a fixed relation between them. In consequence, whenever the value of the two metals altered, these countries acted as equalising machines. They took the metal which fell; they sold the metal which rose, and thus the relative value of the two was kept at its old point. There is no great country now really acting on this system. The Latin Union, it is true, adhered to the name, but they have abandoned the thing. As they do not allow silver to be coined except in limited quantities, they have no longer an equalising action; they no longer receive the depreciated, or part with the appreciated metal, and therefore, the two metals now exchange for one another just as commodities. The gold price of silver is now like the gold price of tin - left practically for the first time without regulation and free from the manipulation of governments."

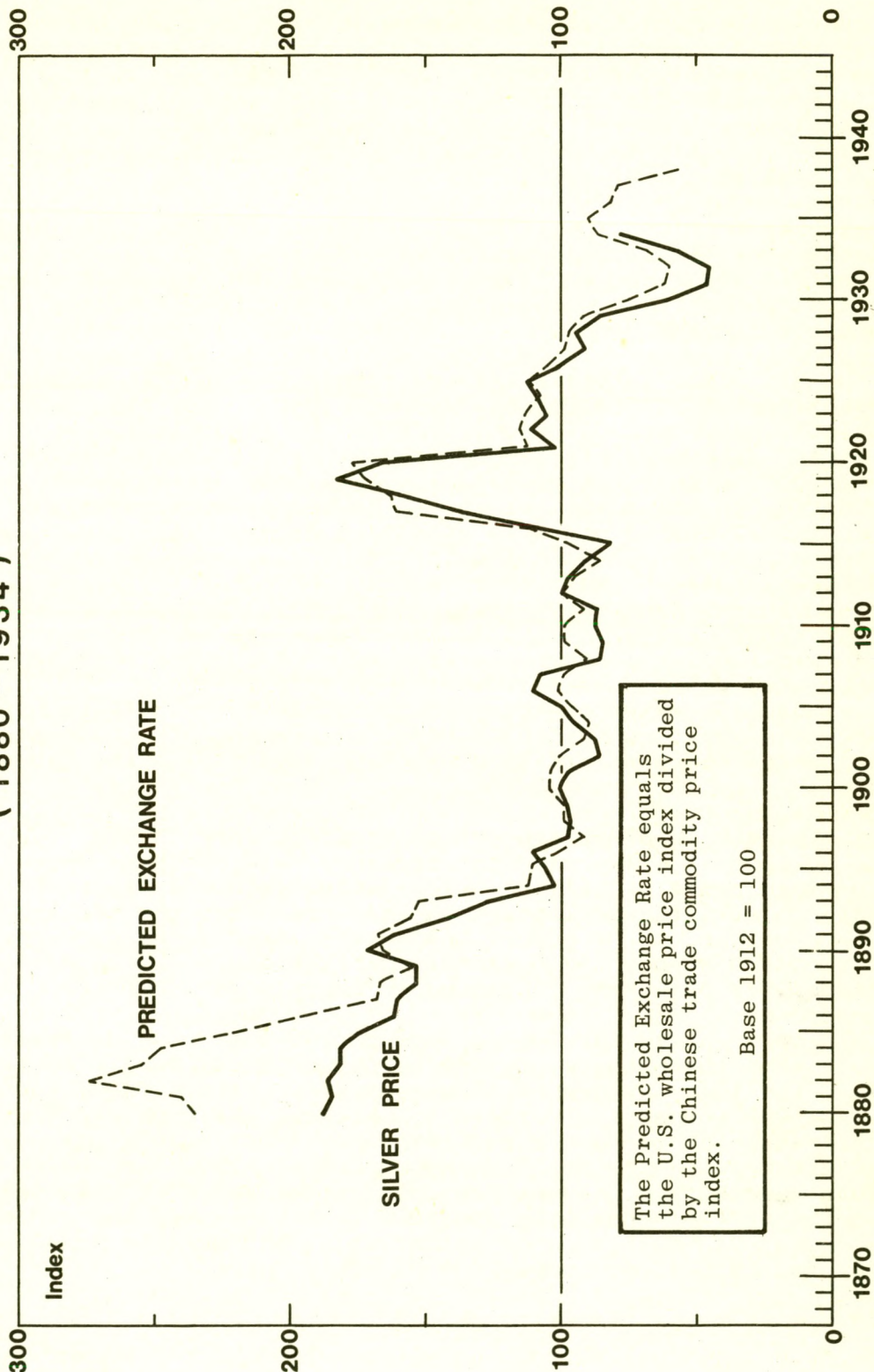
The reduced monetary use of silver was accompanied by a rising world production of the metal. Silver was a side product of the processing of Copper, Zinc and Lead the demand for which was growing rapidly as industrialisation spread through Europe and America. The rate of silver production from these ores was insensitive to its price and continued after the price of silver had been driven down below the break-even point of many pure silver mines. Thus as the stabilizing forces of bimetallism waned in the 1870s silver began to fluctuate in price in response to varying supply and demand and, at the same, time began a secular decline which was to last over sixty years. Part of the decline can be attributed to the general fall in prices in terms of gold which occurred in the last quarter of the nineteenth century. The price of silver declined along with most other commodity prices suggesting that a shortage of monetary gold was at least partly to blame, but the price of silver fell rather further than most other prices reflecting the special factors acting on the silver market. The price of silver slid gently from 60.56 pence an ounce in 1870 to 51.25 pence in 1879, and then on down to 42.69 pence in 1889.

The Silver Standard Countries

The fall in the price of silver was in effect a fall in the exchange rate of silver standard countries relative to gold standard countries. The result was that prices in silver standard countries, in particular India and China tended to be lower than in gold standard countries making the products of the silver

CHART 1 CHINA

THE PRICE OF SILVER IN THE US AND THE PREDICTED EXCHANGE RATE (1880 - 1934)



countries competitive relative to foreign goods both overseas and in their domestic markets. China and India consequently enjoyed relatively favourable trade balances and the inflows of silver had an inflationary impact on their money supplies and stimulated commerce. Whereas wholesale prices in the U.K. fell fairly steadily from 134 in 1873 to 74 in 1896, wholesale prices in China rose over 30% in the same period.* The competitive advantage of the silver standard countries lay in the fact that their prices took time to adjust to the falls in the exchange rate. Though prices were rising in China and India they did not rise fast enough to offset the declining silver prices so that, in terms of gold, their prices remained competitive.

Until the late 1920s there circulated in China a multitude of different silver coins of various degrees of fineness and weight. Mexican silver dollars or Yuan, domestic issues of 'taels' or ounces of silver, 'sycee' or shoe-shaped ingots of silver, and American trade dollars all circulated freely. In addition to the coins, banknotes issued by commercial and provincial banks were also used, and despite their face values they had their own market values depending on the reputations of the issuing banks. In this chaos of competing currencies major transactions were always settled in terms of weights of nearly pure silver. Tariffs and trade were denominated in Haekwan taels which were purely units of account representing specified weights of silver of a certain fineness. The Haekwan tael did not exist in the form of a coin but merely in official accounts, just as the SDR or Special Drawing Right of the International Monetary Fund exists today only in the books of the IMF.

Debts, interest and prices in China were thus all denominated in weights of silver and the exchange rate of China depended on the gold price of silver, which varied from week to week. This was not strictly a floating exchange rate for the exchange rate depended not on the supply and demand for Chinese currency but on the supply and demand for silver and as we have seen the silver price was subjected to many factors outside China and independent from Chinese trade. To have been truly floating the Chinese exchange rate would have had to have been determined solely by the balance of foreign payments of China. As it was, the Yuan was pegged to a commodity price. The movement of silver across the borders of China in the course of international trade and payments was undoubtedly a major factor in determining the world market price of silver and hence the Yuan rate but it was not the only factor and at times events in the rest of the world combined to cause large and sudden movements in the price of silver which had serious consequences for the Chinese economy.

* (1910-1914=100) Warren and Pearson index for U.K. and Index of wholesale prices of import and export commodities in China, Nankai Institute of Economics.

India Abandons the Silver Standard

The erratic behaviour of the price of silver forced India to abandon the silver standard in the 1890s. India was under the tutelage of Great Britain; railways and irrigation works in that country were chiefly constructed with English capital. As the rupee exchange rate fell the debt charges that had to be remitted to the home country became increasingly burdensome. It was felt that the falling rupee was reducing Indian demand for high priced British capital goods, thus, the fall in the price of silver was proving to be unpleasant for Britain as well as the Indian Government.

It was not until the early 1890s that the problem became really serious. Strong political forces in America had an interest in seeing the price of silver stabilized and they were instrumental in getting the Sherman Silver Purchase Act passed by the US congress in 1890. Some believed the newly purchased silver would provide backing for a monetary expansion which would stimulate trade and raise commodity prices; others had interests in the silver mines. The result was that the price of silver rose from 94 cents in 1889 to \$1.05 in 1890. Sir David Barbour - Financial Secretary of India presenting the Budget of 1891/92 said:

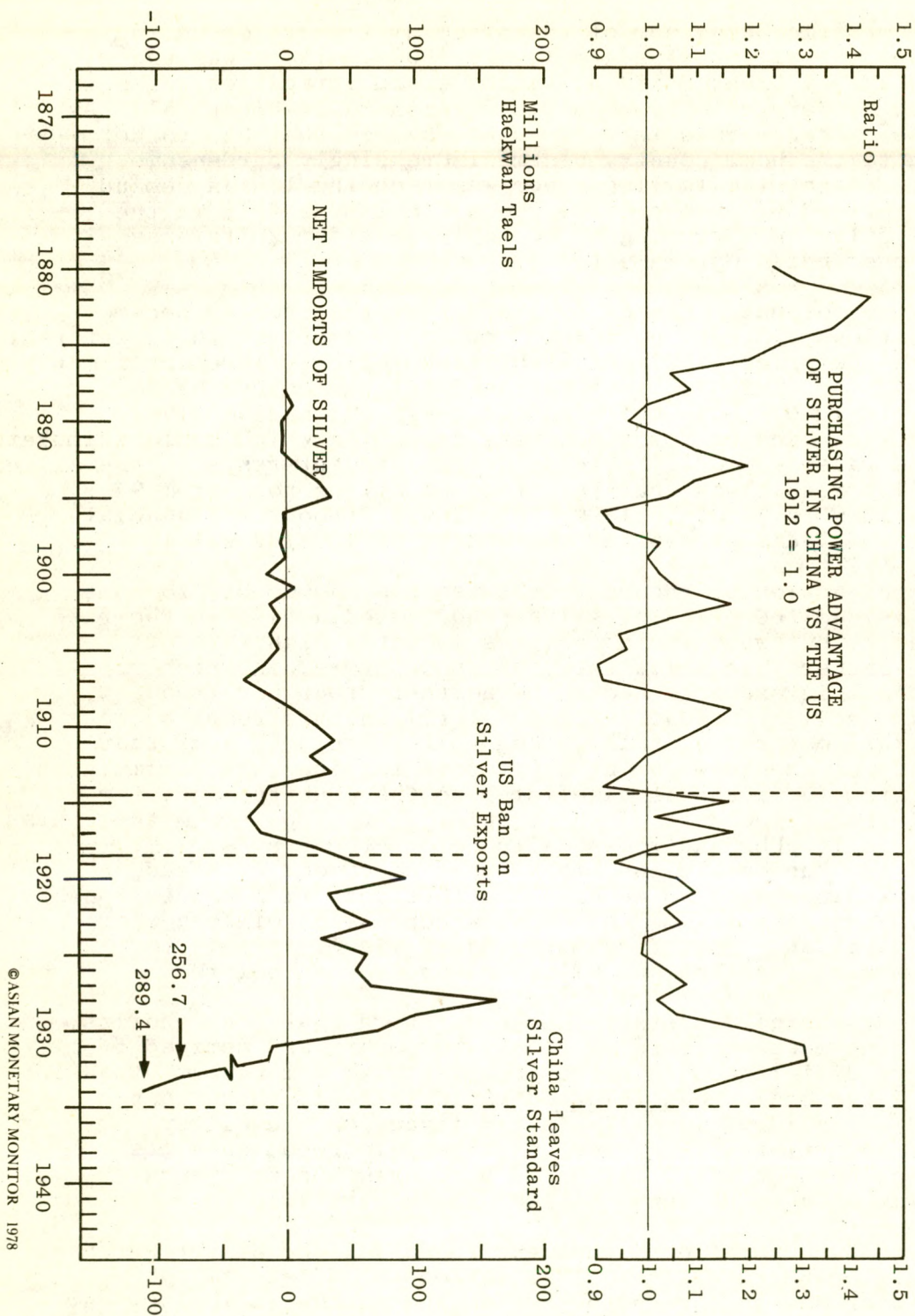
"The recent action of the United States has, no doubt, to some extent, raised the price of silver and caused a rise in the rate of exchange, but what India requires is not a high rate of exchange rather than a low rate, but some system in which fluctuations in exchange should be neither great nor frequent, and shall oscillate round a fixed point. In this respect, we have so far lost rather than gained. It is held by some that a low rate of exchange, or at any rate a falling rate, stimulates exports from India and is beneficial to the country, and, for proof of the correctness of their opinion, they point to the course of trade as it ebbs and flows daily before their eyes."..... (This is an) "untenable and mischievous delusion.....A sudden rise in exchange such as we have had this year will unquestionably check business for a time and cause a depression of longer or shorter duration. But trade must adjust itself in time to the new scale of prices and will then proceed as before."

The Financial Secretary thus understood that the benefits of a falling exchange rate were only temporary and derived from short-term differences in prices coupled with a monetary expansion. However large scale unanticipated rapid falls in the exchange rate had a considerable stimulatory impact on the silver standard countries. The price of silver did recommence its rapid decline soon after Sir David Barbour's budget speech and it was down to 87 cents in 1892 (See Chart 1).

It went on going down when the repeal of the Silver Purchase clause of the Sherman Act in 1893 marked the defeat of the silver interests in the United States and in the following year silver was quoted at 63 cents. In just four years the Indian Rupee and the Chinese Yuan had been devalued by over 30%. Silver flooded into the Far East where prices in terms of gold had not kept pace with the precipitate fall in silver.

The Indian government decided the situation could not and

CHART 2
CHINA
THE NET IMPORTS OF SILVER UNDER THE SILVER STANDARD
(1887 - 1934)



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should not continue. Indian textile manufacturers were now very competitive compared with their British competitors, and the silver prices of British capital goods were now very high. 'The adverse effects upon the trade and commerce of the Indian Empire.....led the Government to consider by what means the evil could be obviated'* and the means they decided upon was a monetary squeeze. In 1893 after a somewhat heavy coinage of Rupees the Indian Authorities closed their mints to the free coinage of silver and no new rupees were added to the circulation, with the natural consequence that as soon as circumstances led to an increased demand for the coin, the exchange value of the rupee began to rise above the bullion value. After a few years it became profitable to exchange gold for rupees or rupee notes at the rate of exchange offered by the authorities of 15 rupees for £1. By this means the rupee was lifted from its intrinsic value to a fiat value, and India was placed on a gold exchange standard. In the Far East both the Philippines and Japan also adopted the gold exchange standard, whereby the authorities undertook to exchange the local currency at a fixed exchange rate for a currency which was in turn convertible into gold, and it was essentially the same as the fixed exchange rate system which was set up at Bretton Woods in 1945.

In principle the gold standard was beautifully simple. Each country guaranteed to exchange its currency for gold at a fixed rate. Because the banks had to be able to give gold in exchange for currency they had to maintain a prudent reserve of bullion in proportion to the money supply. The maintenance of this ratio of money to gold meant that the money supply was regulated by the changes in the gold stock, which rose and fell as gold entered and left the country. The net influx of gold was determined by the balance of payments. When the balance of payments was in deficit there was a net outflow. Thus, when there was a balance of payments deficit there was a consequent reduction in gold reserves which led to a credit contraction and a rise in interest rates. The balance of payments was brought back into equilibrium, by both an inflow of capital attracted by the higher interest rates and a decline in demand for imported goods. An analogous but reciprocal process occurred in a country with a balance of payments surplus. Interest rates fell and the money supply expanded so that capital left the country in search of higher yields and the demand for imported goods rose, both factors tending to bring the balance of payments back into equilibrium.

There was nothing wonderful about gold itself. The great merit of the gold standard was that it was automatic. Countries automatically deflated or reflatd to rectify balance of payments disequilibria without the need for government action and it required a conscious act of intervention to interrupt the specie-flow mechanism.

Economically, the system bonded the gold standard countries together in a monetary union. A US dollar note represented a specified weight of gold for which it was exchangeable usually on demand at a bank. Similarly one pound sterling was exchangeable

* Foreign Exchange and Foreign Bills W.F. Spalding London 1928.

for another specified weight of gold in the form of a gold coin - the sovereign. The dollar and the pound sterling therefore represented different denominations of the same currency - gold; just as the dime and the quarter are in fixed ratios to the US dollar, the US dollar was in a fixed ratio to the pound sterling. Fixed exchange rates meant that prices and interest rates throughout the trading world moved approximately together, and, because the world banking system used only the one commodity, gold, as a reserve base - a commodity whose limited supply grew only slowly - there was no inflation.

As China was on silver and not gold, prices, interest rates and economic activity in China began to diverge from those experienced in gold standard countries when the price of silver began to fluctuate on world markets.

What was the effect on China of the dramatic 30% decline in the silver price between 1890 and 1894? At first, the internal price level was hardly affected; the wholesale prices index moved from 46.5 in 1890 to 45.9 in 1892, then, as the external purchasing power of silver deviated further and further from the internal purchasing power, it became immensely profitable to buy silver at its London gold price, export it to China and there use it to buy gold or commodities at Shanghai prices. In the three years 1890 to 1892 China had in fact been a net exporter of 10 million Haikwan Taels of silver, but in the following three years over 71 million Taels flooded in and this presumably fueled a considerable expansion in credit. In 1893 wholesale prices rose 5% and in the following year they rose a further 21%. By 1896 silver's purchasing power in China had been reduced to parity with its purchasing power abroad and the influx of silver stopped. (See Chart 2)

Purchasing Power Parity and the Exchange Rate

Over the next two decades the imports of silver waxed and waned as the purchasing power of the white metal became greater alternately in the eastern empire and then in the western nations. It is apparent from the examination of relative price levels that the Chinese exchange rate and wholesale prices in China were closely related. The US dollar price of silver and relative price movements in China and the US track very similar courses during the half century before the abandonment of the silver standard in 1935, affording one of the earliest demonstrations of the purchasing power parity theory. (See Chart 1)

The equilibrating process worked in two ways to bring relative prices and the exchange rate into equilibrium. If prices in China were relatively higher than in the gold standard countries the Chinese balance of payments deteriorated and the Haekwan Tael Telegraphic Transfer exchange rate weakened until it diverged from the price of silver sufficiently to make the export of silver from China profitable. The exported silver would be sold on world markets thereby tending to depress the price of silver. Reducing the price of silver reduced prices

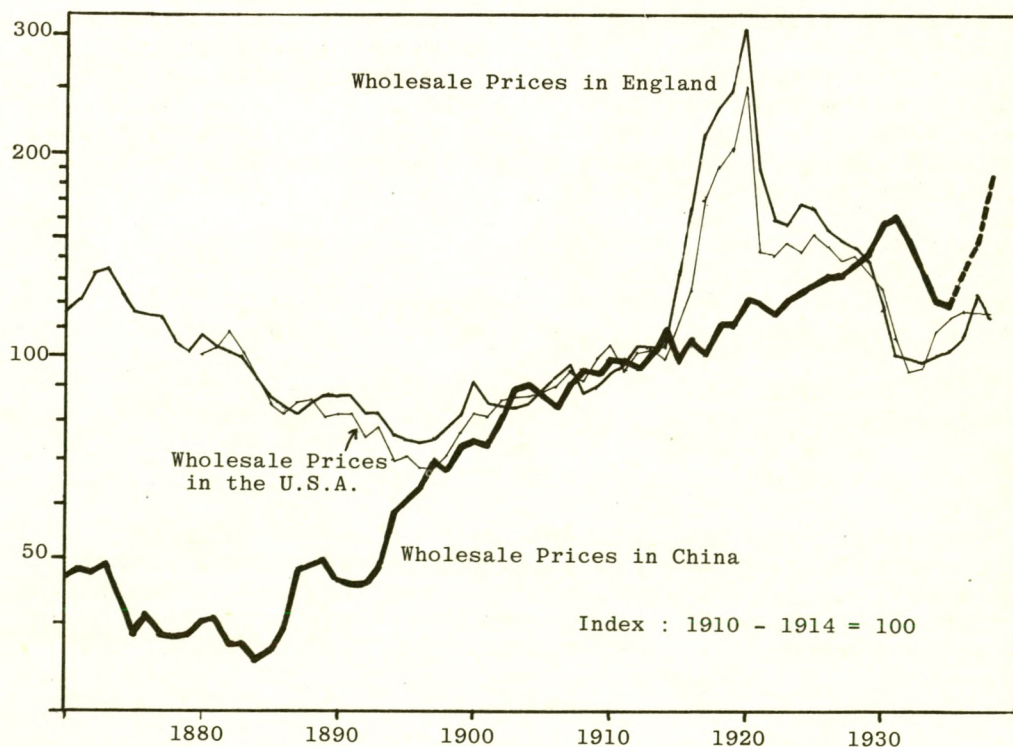
in China relative to prices in gold standard countries, bringing the system back into equilibrium. At the same time, the outflow of silver from China caused a monetary squeeze, tending to depress activity and reduce domestic prices. Prices in China were reduced relative to prices in the rest of the world by both a reduction in the price of silver and a reduction in domestic prices in terms of silver (See Chart 2). Naturally the price of silver was subject to forces of supply and demand outside China so how much of the equilibrating process occurred through changes in the exchange rate (i.e. the price of silver) and how much derived from domestic price adjustments is difficult to say. That the domestic prices bore the brunt of adjustment is suggested by the fact that wholesale prices in China trailed the fluctuations in the price of silver by about a year. Later as international trade and communications expanded, the lag became shorter.

The erratic behaviour of the silver price was almost universally deplored. 'Silver has come to be regarded as a depreciated metal unduly subject to sentimental influences of all kinds*.....' 'The greatest uncertainty prevails among both (exporting and importing) sections of the community.' 'Business operations become converted into gambling transactions, wherein neither expert opinion can guide nor caution protect the shippers.' Yet the fluctuations in silver may have had a beneficial effect which passed unremarked upon until the 1930s, and that was that the silver standard was inherently counter-cyclical.

**Ibidem*

CHART 3

WHOLESALE PRICES IN CHINA, ENGLAND AND THE U.S.A.



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In most recessions the price of silver in gold standard countries plunged as commercial demand for the metal fell. Like most commodity prices, the silver price tended to fall rather further and more sharply than prices in general, with the result that prices expressed in terms of silver rose rather than fell during recessions. This phenomenon was especially marked in 1893, 1907, 1920 and 1929 - all years of severe recession in the United States.

When the price of silver crashed, China experienced a rapid devaluation of her currency making it profitable to import silver and buy Chinese goods, so China experienced an inflation of her money supply and a competitive advantage in world markets exactly when the world of gold was going into recession. The fillip it gave to commerce to a considerable degree compensated for the depressed world markets.

Had China not been such a dismally backward and lawless country she might have been better able to take advantage of these opportunities than she was. What manufacturing she had was concentrated in the coastal cities and then principally only in Shanghai. Communications and trade in the interior were difficult and constantly under the threat of banditry. Very large price differences could be sustained between one region and another without the equilibrating forces of trade operating to erode the disparities. Added to the economic backwardness was the political instability of the period. The Boxer rebellion disrupted trade in 1900 then the revolution of 1911 was followed by the warlord era when China was racked by endless provincial wars. In the early thirties, war with Japan and the growing communist forces further disrupted activity. The economic effects of the silver standard were thus heavily obscured and distorted by the other political and economic developments in the country. Nevertheless there is considerable evidence to suggest that the silver standard insulated China from the severe effects of recessions in the gold standard countries. Prices in China on the whole were more stable in the period 1870 to 1930 than they were in gold standard countries despite her considerable domestic turmoil. (See Chart 3)

Wholesale Prices in the U.S. and China during U.S. recessions

<u>Percent Change</u>	<u>US WPI</u>	<u>Price of Silver in New York</u>	<u>Chinese WPI</u>
1893-4	- 10.2	- 19.0	+ 21.0
1907-8	- 3.2	- 19.8	+ 5.3
1920-1	- 36.7	- 38.0	- 0.5
1929-31	- 23.0	- 45.2	+ 14.4

It is clear from the table above that in the four US recessions considered, the price of silver fell further than wholesale prices in general in the US. Wholesale prices in China rose in three of these periods and fell by only a minimal amount in the other period.

Just as the silver standard enabled China to avoid the sharp deflation experienced in the rest of the world she was also insulated from the booms. During the First World War prices doubled in the US and tripled in the United Kingdom yet, because the price of silver also rocketted, prices in terms of silver were relatively unaffected. Chinese wholesale prices rose only by a quarter. In the half century until China left the silver standard the country experienced intermittent mild inflation but avoided the major price fluctuations experienced elsewhere. China quite unintentionally achieved moderately stable domestic prices at the expense of having a variable exchange rate.

While exchange dealers and Shanghai traders could clearly and immediately perceive the erratic foreign exchange rate movements, they could not so readily appreciate the movements in prices in foreign continents. As always the particular price was more readily discernible than the general price level, with the result that there was a clamour to stabilize the particular price - the exchange rate - while the consequences for the general price level were neglected.

It is ironic that it was deliberate government intervention to 'stabilize' the price of silver which eventually forced China to abandon the silver standard in the 1930s. The actions of the US government to restore the price of silver to its 'correct' level imposed a ruinous deflation on the Chinese economy and threatened to drain the country of its entire stock of monetary silver. The fall of the silver standard came after a period of twenty years during which the stabilizing properties of the system were demonstrated to their best advantage. During that period China experienced steady inflation while avoiding the explosive inflations experienced in the West during World War I and the sharp recessions and deflations of 1920 and 1929. These final years of the silver standard and the events leading up to its abandonment will be examined in the next issue.

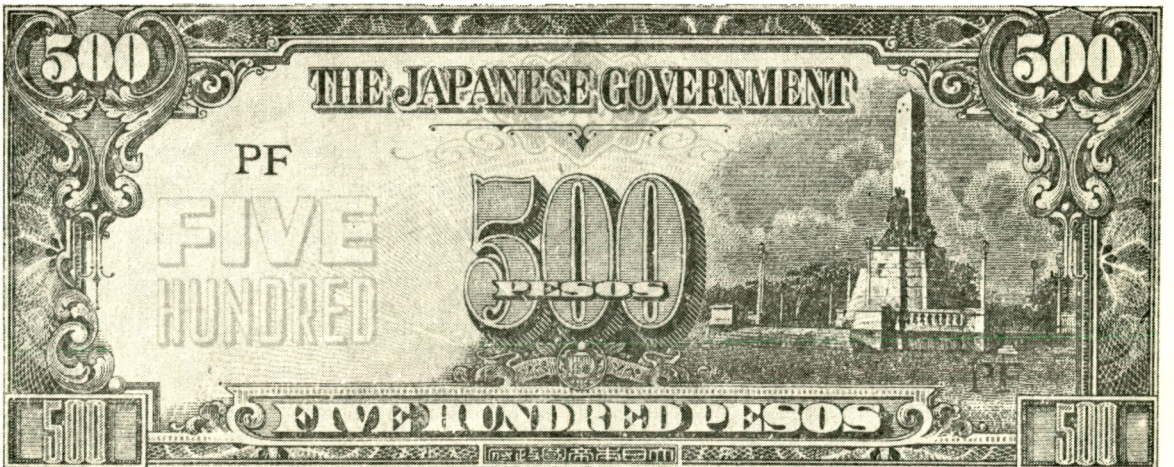
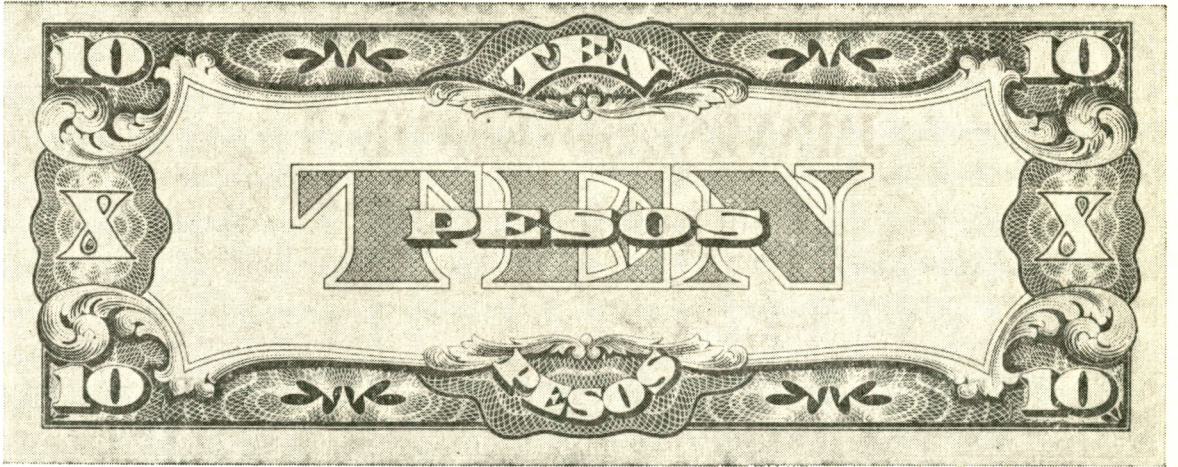
JAPANESE OCCUPATION CURRENCIES (2)



Japanese forces captured Manila on January 2, 1942. On January 3 a proclamation was issued introducing Japanese military notes or "military pass-money" as currency to circulate at par with the Philippine peso. Dire punishment was threatened to those who refused to accept the notes, and foreign currencies - including the yen - were forbidden, although the US dollar was permitted to circulate for a few weeks at an approved exchange rate of two pesos to the dollar.

Filipino traders were understandably reluctant to accept the inconvertible notes, and the Japanese peso soon went to a discount to the Philippine peso. Following Gresham's Law the genuine Philippine peso was hoarded, almost disappearing from circulation, while the "Mickey Mouse" money circulated at a fraction of the purchasing power of its hoarded counterpart. When three Filipino banks were ordered to re-open for business in February 1942 there was a immediate stampede to convert deposits into currency, prompting the Japanese authorities to limit withdrawals to ₱500 per person per month. Also, in an attempt to restore the level of bank deposits another proclamation ordered all government offices, banks, and private businesses to deduct from the salary of each employee a certain amount to be deposited, by the employer, in banks.

The original Japanese invasion force numbered about 64,000 troops, mounting in time to around 200,000. These men were to be provisioned almost entirely from local supplies, and large quantities of commodities were to be shipped out to Japan and the Japanese armies elsewhere in Asia. In the Philippines these goods were procured either by confiscation or in exchange for Japanese war notes. As the Japanese war needs expanded and inflation accelerated, so did the note issues - from nine million pesos per month in early 1942, to 38 million by December 1943, 119 million pesos in April 1944, and over a billion pesos in December 1944. Manila was finally liberated from the Japanese - and their printing presses - in February 1945.





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KEY TO SYMBOLS USED IN THE CHARTS

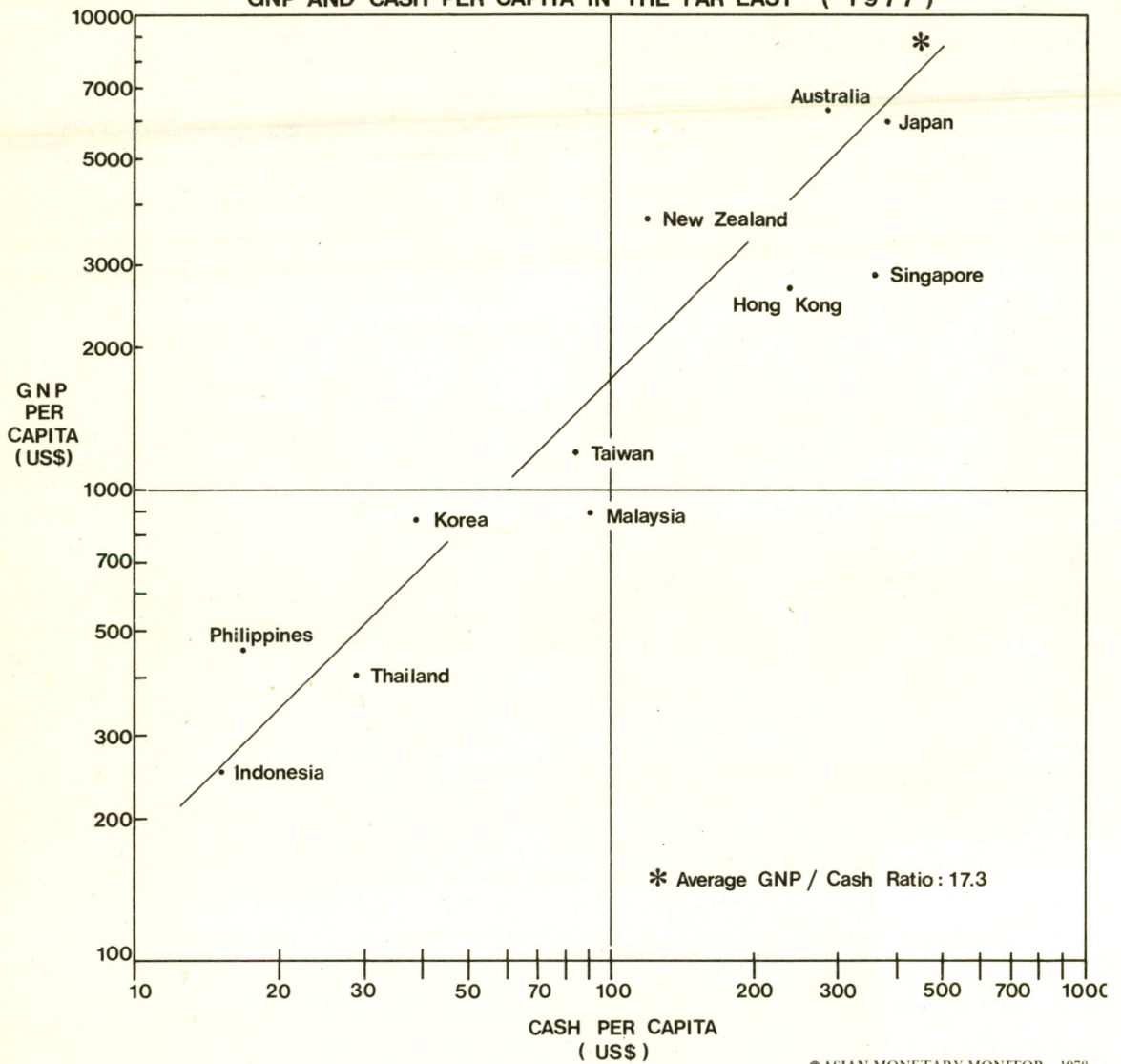
% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

CHART 1
GNP AND CASH PER CAPITA IN THE FAR EAST (1977)



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REGIONAL SURVEY

TOWARDS A CASHLESS SOCIETY ?

"Of course, money is not everything, as the saying goes. But you must have it in one form or another. The diversity of instruments that do much the same thing as money is taking the world towards an almost cashless society. In the following pages ASIAN FINANCE presents the concept and practice of those peripheral services of banks and finance companies that may well outmode the use of cash. They include credit cards, travellers cheques, leasing programmes, and above all, the computers that make the miracle both possible and complete." (ASIAN FINANCE, 15 August 1978, p.37)

The hypothesis to be tested is that as societies become richer or more financially sophisticated, their use of banknotes and coin diminishes, at least in a relative sense. In order to examine the proposition it is necessary first to decide on some definitions, and second to devise several tests which are appropriate not only to one society through time, but also to different societies at the same point in time.

As an indicator of wealth it seems reasonable to use GNP per capita, though in making comparisons between countries it is necessary to translate these statistics into a common currency. There are, admittedly, a variety of problems in making direct trans-national comparisons of GNP, but in the absence of any other satisfactory measure which avoids similar pitfalls it does not seem unreasonable to use a broad measure of income per capita as a proxy for wealth. Financial sophistication is a less scientific or more subjective quality which perhaps can only be assumed to grow over time in line with technological improvements in the banking and financial industry. Of course such improvements or innovations need not occur at a uniform pace. Also, given the wide range of average incomes in different countries alongside a high degree of integration in international financial markets, it would be quite normal to expect such innovations to be introduced into different countries at quite different stages of their economic development. For a simple test, therefore, we first compare per capita GNP (in US\$) with holdings of cash currency (banknotes and coin) by the non-bank public in nine countries of the Asia-Pacific rim, together with Australia and New Zealand. The result is shown in Chart 1 opposite.

The Chart appears to demonstrate that there is some relationship between the level of cash currency per capita and GNP per capita. Not surprisingly, one finds that the richer countries have higher currency holdings per capita, but the relationship is not very close. Though the simple average of the GNP/cash ratios of the countries considered is 17.3, the range is quite wide: Singapore's is 7.6 while New Zealand's is 31.2.

The interesting point is that irrespective of the level of per capita income in the countries featured in this chart, the holdings of cash currency do not seem to diminish

* The basic idea for this survey was suggested by Milton Friedman in Hong Kong in September 1978.

proportionately (or, indeed, in any other fashion) as income levels rise. In fact, two of the richest countries, New Zealand and Australia and two of the poorest countries: the Philippines and Indonesia have high GNP/cash ratios. For the time being, therefore, based on this cross-section test, our conclusion must be that countries in the Asian Pacific region do not appear to be moving towards a cashless society.

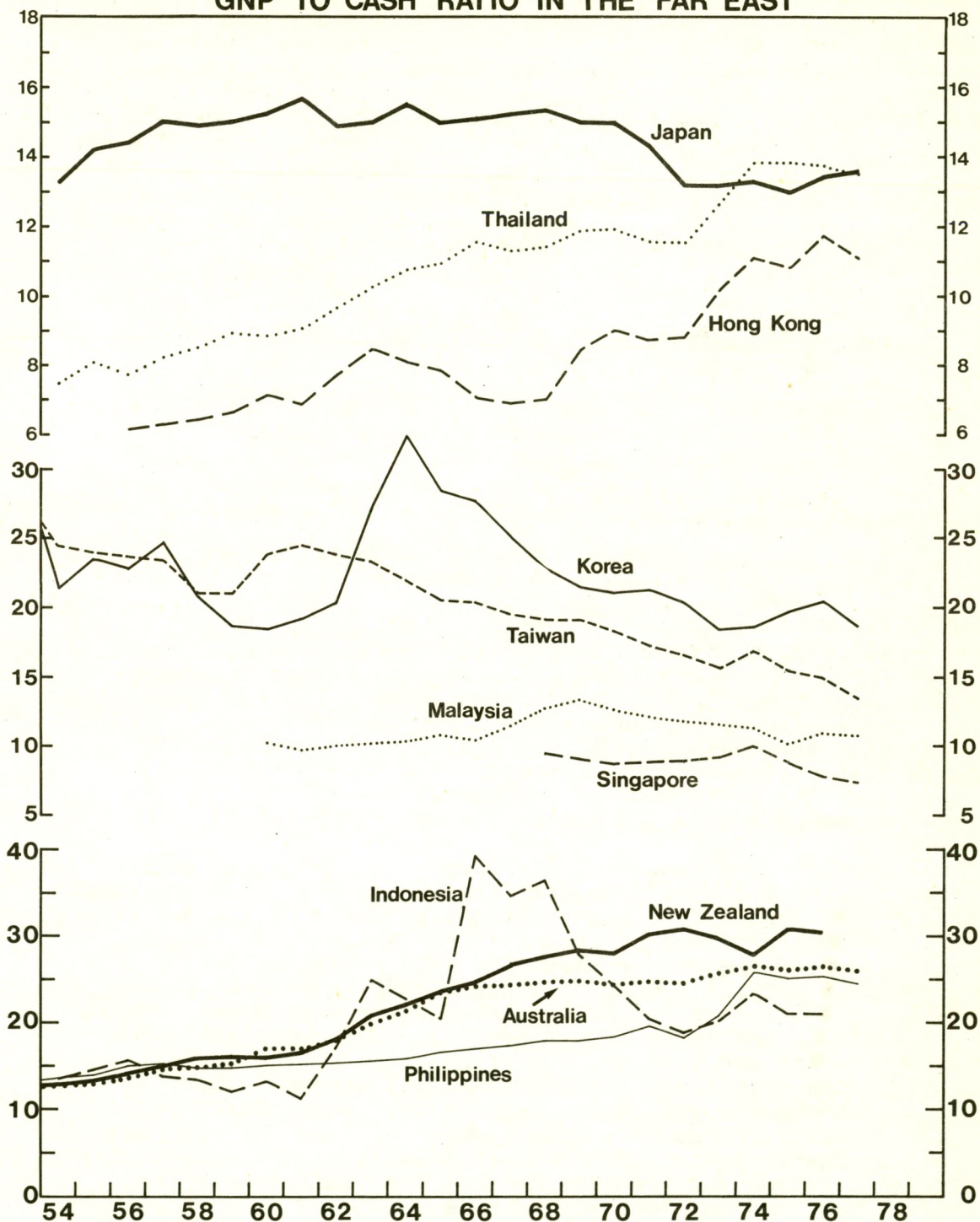
Is there any other evidence which might be brought to bear on the question? After all, it is quite clear to any casual observer that a great variety of cash substitutes - such as cheques, credit cards, and travellers cheques in different currencies - are becoming available, so how can it be that banknotes and coin are not becoming any less significant?

One possible answer is that the whole line in Chart 1 is gradually shifting upwards through time. Therefore, by taking a particular period of time (the average levels of per capita GNP and per capita cash currency in 1977), such changes are concealed. This possibility can be checked by calculating the ratio of per capita GNP to per capita cash currency in local currency terms through time. The only problem with this technique is that whereas 1977 was a relatively normal year for most of the countries concerned, some years in the past might produce somewhat abnormal samples. For example, the Indonesian hyperinflation of the mid-1960s (see AMM Vol. 2, Nos. 2-3) and the immediate post-Korean war inflation in S. Korea greatly distorted the GNP/cash ratio in those countries.

Nevertheless, Chart 2 shows the ratio of GNP to cash currency (which is identical numerically to the ratio of GNP per capita to cash currency per capita) for all the different countries as far back as we have been able to obtain the data on a consistent basis. The simple average of the GNP/cash ratios of the eleven countries has indeed risen from 14.1 in 1960 to 17.3 in 1977, but here again the average tells only part of the story.

Since the 1950s the GNP/cash ratio has risen in Thailand, Hong Kong, Indonesia, New Zealand, Australia and the Philippines. In Malaysia the trend is flat while Japan, Korea and Taiwan have experienced some decline. Four countries in particular stand out as being anomalous. Whereas for most of the countries examined the GNP/cash ratio moved approximately in line with the trend in velocity (the GNP/M_2 ratio) indicating that the balance between holdings of cash and deposits was relatively stable, in Japan, Hong Kong, Thailand and Malaysia velocity and the GNP/cash ratio diverged. In these countries bank deposits grew very much faster than currency holdings. This divergence may be explained by the interaction of two contrary developments. On the one hand, increases in GNP are matched by increases in holdings of all financial assets. Since cash currency holdings are part of the broad spectrum of financial assets they grow along with the aggregate. On the other hand, the development and expansion of a banking system and of credit markets offering liquid assets more attractive than cash tends to reduce the desired proportion of cash in the total of financial asset holdings. In Hong Kong and Thailand the second

CHART 2 GNP TO CASH RATIO IN THE FAR EAST



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factor - the diversification of financial assets - probably predominated causing the GNP/cash ratio to increase even though the GNP/M₂ ratio fell. In Japan and Malaysia the second factor was at least sufficiently dominant to keep the GNP/cash ratio stable throughout the 1960s even though velocity dropped considerably. Unfortunately we have been able to obtain statistics on financial asset holdings only for Japan, but from this data in Table 1 it is apparent that asset diversification has been an important factor keeping the GNP/cash ratio stable despite the fall in the GNP/Financial Assets ratio.

Table 1

JAPAN

Year End	<u>G.N.P.*</u>	<u>P.F.A.</u>	<u>G.N.P.</u>
	P.F.A.	Cash	Cash
1961	1.24	11.6	14.4
1965	1.04	13.6	14.1
1970	1.03	13.4	13.9
1975	0.87	14.4	12.6
1977	0.81	16.1	13.0

* P.F.A. : Personal Financial Assets

G.N.P. : Gross National Product

In other countries the forces of accumulation and diversification have not been so finely balanced and they have therefore experienced trend increases or decreases in the GNP/cash ratio. Credit cards, cheques etc. are just some of the devices by which cash holdings are made relatively less desirable or necessary for the individual, but they probably have little effect on the desired total value of his holdings of financial assets, except perhaps by their effect on the generation of wealth - a rather theoretical point.

Cheques, for instance, are simply technological devices for transferring balances from one deposit account to another, and the credit card simply reduces the risk borne by the seller of the goods or services by transferring that risk of default to the issuer of the credit card. By interposing a large supposedly reputable bank or other agency between buyer and seller, the transaction is facilitated for both sides because the buyer is instantly recognised as creditworthy while the seller is assured that the amount he is owed will be settled. What is the effect of such technological devices? Do they raise incomes and wealth by facilitating these transfers of bank deposits, or do they only reduce the need for cash and thereby hasten humanity's approach towards the "cashless society"? If credit cards and the like do both i.e. raise income and reduce the need for cash at the existing level of income, then the explanation for a stable ratio of GNP to cash currency must be that at the new, higher level of income, additional cash balances are required to finance more transactions, to hold as assets etc. In other words one aspect of specialisation and the increasing division of labour is that more transactions

are generated and/or more cash currency is held as an asset to meet unexpected circumstances.

Whatever the reasons, the persistence of stable trends in the relationship between GNP and cash currency in many countries over long periods of time ought to command the utmost respect of policy-makers and economic commentators alike. Though a rising GNP/cash ratio in some countries may be related to the development of credit cards and the like, there are also many countries where similar trends in the ratio can hardly be attributed to the same cause. It is still too early for economic commentators to claim that recent technical innovations in banking imply we are moving towards a cashless society.

JAPAN

FINANCIAL INDICATORS OF RECOVERY

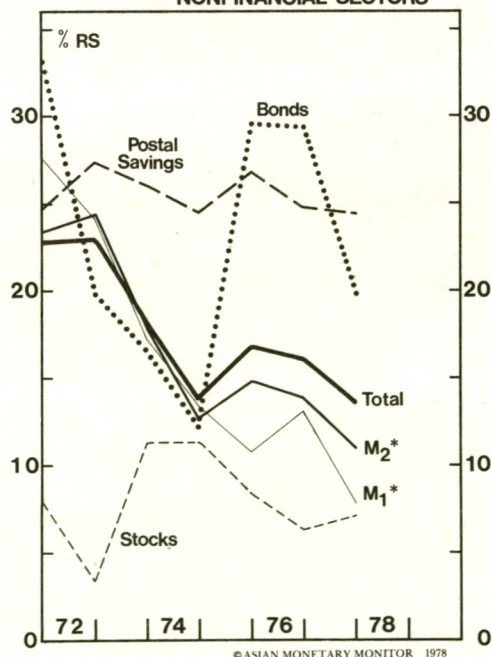
In the January-March quarter of 1978, for the first time in at least twenty years the corporate business sector in Japan recorded a surplus in the national flow of funds accounts on a seasonally adjusted basis. In other words, in only five years the corporate sector has turned from being the largest recipient of new funds to being a net donor of new funds in financial markets. This astonishing development highlights the revolution that has been taking place in Japanese financial markets since 1973. Before that date the public sector financial deficit had usually been no more than three percent of GNP, but as tax revenue fell relative to expenditure during 1974 and 1975 the deficit grew to over 8% of GNP. In 1976 there was some respite and the deficit fell below 7%, but, with the adoption of a more stimulatory fiscal policy last year the deficit again rose towards 9% of GNP. Counter-balancing the expanding public sector deficit the corporate sector has moved in the opposite direction: the corporate deficit has declined from a peak of over 9% of GNP in early 1974 down to about 2% of GNP by the end of 1977, and even recorded a surplus in the first quarter of this year. The personal sector, in contrast, has shown less change. It remains the largest supplier of funds with a financial surplus which has risen from around 8% in the mid sixties to over 11% of GNP by 1977. All in all, the private sector, including both the corporate sector and the personal sector, has shown a strong tendency to increase savings and reduce investments leaving the government, public corporations and local authorities as the only major deficit spenders.

The Private Sector

This tendency for the private sector to increase holdings of financial assets has been especially marked in the past four years when the ratio of the Outstanding Financial Assets of Non-financial Sectors to GNP has been rising steadily, even though Marshall $k\left(\frac{M_2}{GNP}\right)$ has

been virtually flat. This is because the private sector has been diversifying its portfolio away from cash and bank deposits towards higher yielding financial assets such as postal savings and bonds (see Chart 1).

JAPAN
CHART 1 : FINANCIAL ASSETS OF
NONFINANCIAL SECTORS



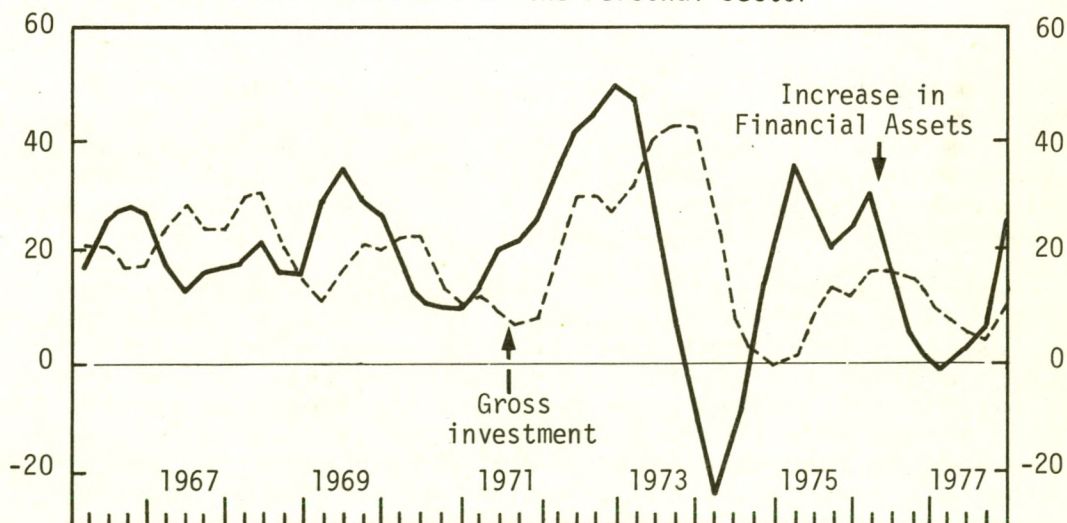
* Flow of Funds definitions, similar to M_1 and M_2 but covering more institutions.

Within the private sector, the personal sector rather than the corporate sector has experienced the fastest growth of financial assets: the personal sector's financial assets grew from 76.6% of the total outstanding in 1974 to 80.3% at the end of 1977. There are several possible reasons for this. Firstly, after the severe liquidity squeeze of 1973-74 the corporate sector has been reducing its dependence on debt in order to reduce the fixed cost burden of interest payments, so at least part of the improving corporate cashflow has gone to reducing liabilities rather than accumulating assets. Secondly, the share of national income going to the corporate sector fell from around 10% in 1973 to under 5% in 1977 but the share of employee compensation rose from under 60% to nearly 67% in the same period. This shift in incomes has increased the relative ability of the personal sector to accumulate financial assets and reduced the relative ability of the corporate sector.

Recent work by the Bank of Japan bears this out. Not only has the personal sector enjoyed less volatile income growth but the rate of growth of personal financial assets has also been relatively more stable than the growth of corporate financial assets. It seems that when credit is tight corporate financial asset holdings suffer more than personal holdings, and it is the corporate sector rather than the personal sector which first feels the effects of changes in monetary policy.

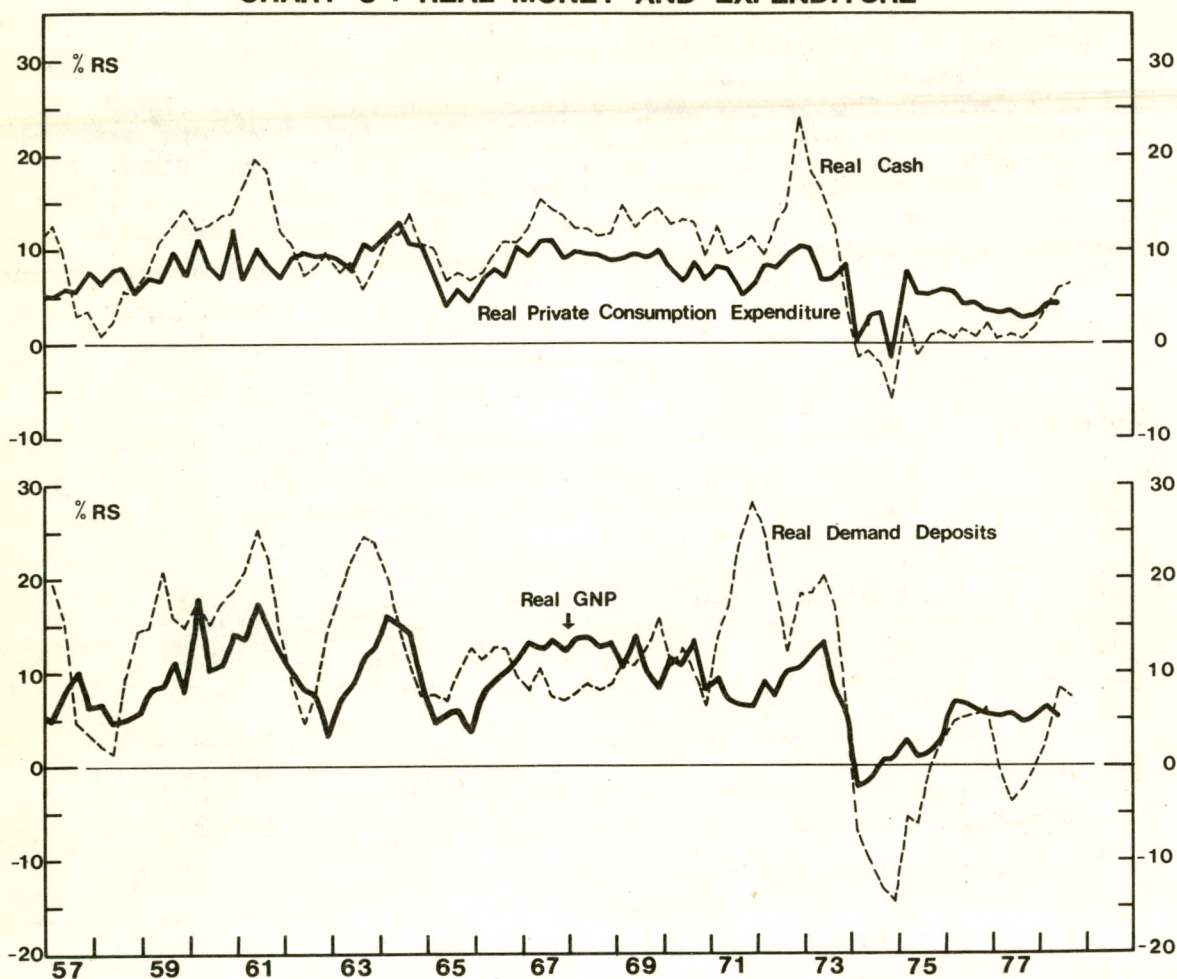
The relationship between personal financial assets and personal gross investment expenditure which is shown in Chart 2 is quite close and stable. It appears that the major effect of an increase in financial assets is not initially on personal

Chart 2
Increases in Financial Assets and
Gross Investment of the Personal Sector



Note: Year-to-year comparisons in weighted three-quarter moving averages.
(Source : Bank of Japan)

JAPAN
CHART 3 : REAL MONEY AND EXPENDITURE



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consumption expenditure but on investment in durables and housing and that an upturn in consumer investment can be expected around six to nine months after an upturn in personal financial assets. Towards the end of 1977 personal financial assets grew sharply and the subsequent effects of this are being seen in the high housing demand and the upturn in car sales in 1978.

The relationship between financial assets and Personal Sector investment may be explained by savings behaviour. If the Japanese individual saves hard in order to buy a house or a car, his financial assets will accumulate until he has enough to pay either the down payment or the total purchase price. In other words, he will try to bring his stock of financial assets into some relationship with the price of the desired investment. The relative values of his financial assets and his desired investment are vitally affected by two factors: the rate of interest and the rate of inflation. In the latter half of 1977 both factors moved in the direction which made his desired purchase easier. Interest rates fell substantially, reducing

the returns on his assets but making housing loans cheaper. At the same time the rate of inflation slowed and house prices stabilized.

Consumer demand in other areas is not so strong and this has led some commentators to doubt whether the present recovery will persist, but as we have seen, general consumer demand is not a particularly sensitive indicator of the initial stages of recovery and consumer durables are a far better guide.

A further insight into consumer behaviour is given by examining the rate of growth of cash currency in circulation. Since cheques are hardly used in Japan the amount of cash in circulation is a good indicator of consumer expenditure. Here again the rate of growth of cash currency has been rather more stable than the growth of the monetary aggregates suggesting that personal sector behaviour patterns are innately more stable compared with the volatile corporate sector. It is particularly noticeable that the nominal value of cash in circulation has only partly reflected the variations in the inflation rate suggesting that nominal consumer spending has also been more stable than real consumer spending.

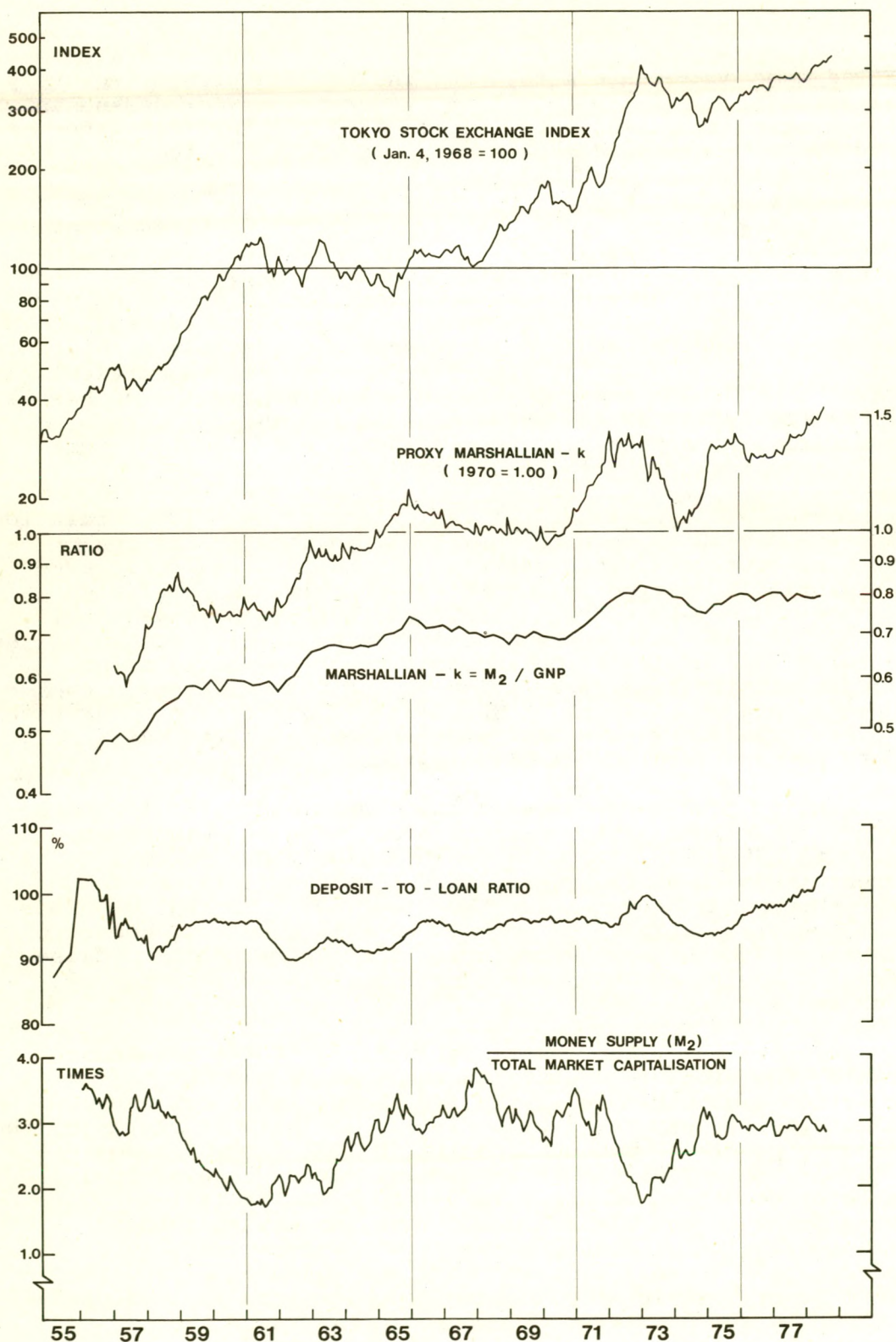
The rate of growth of the real value of cash in circulation shown in Chart 3 appears to be closely related to the real growth of consumption expenditure. Since 1973 real cash grew at historically extremely low rates and this was paralleled by sluggish real consumer expenditure, but at the end of 1977 and in 1978 real cash began to grow faster (mainly because of the declining rate of inflation) and this can be expected to be reflected in the real consumption expenditure figures in due course. Data on the Bank of Japan note issue (a proxy for cash in circulation) suggests that even in nominal terms cash currency growth has accelerated slightly in recent months.

Just as cash currency appears to be closely related to consumption expenditure, demand deposits can be related to aggregate GNP. The corporate sector holds about 60% of the current deposits which are included in the definition of M_1 and the personal sector holds the other 40%. Current deposits are therefore likely to be correlated with the total amount of activity in the economy - including the export sector because current deposits are used for corporate transactions for all goods and services.

Unfortunately, the relationship is not quite so straight forward: the broader monetary aggregates are subject to careful regulation by the Bank of Japan and therefore do not passively reflect the current level of activity, so that for instance, the explosive growth in demand deposits in 1971 was a consequence of highly expansionary monetary policy rather than explosive economic activity. In other words the causal relationship between demand deposits and GNP is rather more two-way than the corresponding relationship between cash and consumption expenditure. Whereas cash currency and consumer expenditure move more or less in step, demand deposits tend to lead changes in GNP by a few quarters. (Compare for instance the two relationships for the period 1963-65.) Nevertheless the

JAPAN

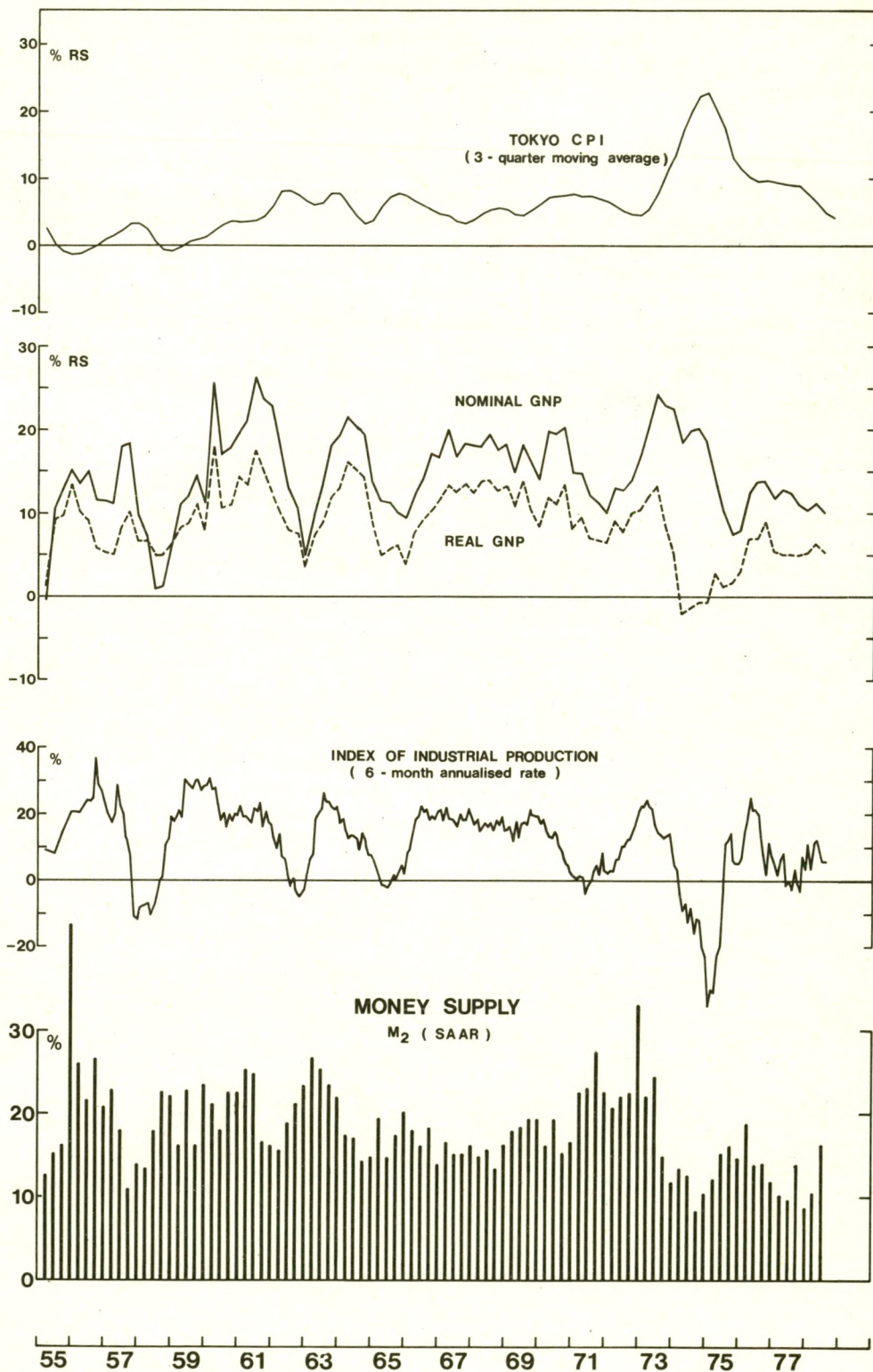
CHART 4 : THE STOCK MARKET AND 4 LIQUIDITY INDICATORS



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JAPAN

CHART 5 : MONEY, OUTPUT, AND PRICES



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relationship is illuminating. The revival in real GNP growth in 1976 was reflected more in the real growth of deposits than in the growth of cash balances showing that real consumer demand was still weak but that other areas, particularly exports, were strong. In 1978 both current deposits and currency have recovered indicating perhaps that the economic growth is more broadly based.

FORECAST: Examination of the recent changes in the holdings of various financial assets points to a recovery in consumer expenditure which is likely to be stronger than at any time since the oil crisis. The pick-up in personal investment expenditure (cars and housing etc.) is already being seen, while the real growth in cash balances indicate a more general recovery. The real growth in current deposits which has in the past been related to the trend in overall activity also indicates higher real GNP growth in future.

NEW ZEALAND

THE SLOW FIGHT AGAINST INFLATION

The worldwide inflation of 1973 generated a tremendous increase in all prices. Many major countries are still experiencing rates of inflation very much higher than were considered acceptable in the fifties and sixties. But a general price increase was only one consequence of the monetary policies pursued six or seven years ago, another was the distortion in relative prices to which the inflation gave rise. The speculative commodity boom of 1973 raised commodity prices dramatically relative to the prices of manufactured goods and in particular, the quadrupling of the price of oil - though a 'political' move - was also undoubtedly provoked by the prevailing inflationary environment. The subsequent recession and the collapse of the commodity markets brought further disruption and for most countries economic recovery since 1975 has been slow and painful.

New Zealand was a casualty of these years. The combination of external events with unfortunate domestic policies led to accelerating inflation, serious balance of payments problems and a large devaluation of the New Zealand dollar in 1975. In many ways the story of New Zealand is the story of Australia writ small. Both countries have suffered two periods of highly expansionary monetary growth. In each case, the first was largely generated by the balance of payments in 1972-3; the second was domestically generated in 1975-76. However, after the election of Mr. Fraser's government in 1975 Australia has abruptly changed course (See AMM Vo. 2 No. 3). A slowdown in monetary growth has brought inflation down and reversed the deterioration in the balance of payments. Unfortunately New Zealand has not had the same success.

To a large extent the similarities between the experiences of New Zealand and Australia arise from their similar economic structures. In particular, both countries are primary commodity exporters and are very susceptible to fluctuations in their terms of trade. In the 1970s three factors have had an important effect on the balance of payments. The first is the terms of trade or the relative movements of the prices of New Zealand's exports and imports. The second is inflation. Though it is probably true that the relative prices of exports and imports are to some extent influenced by New Zealand's domestic monetary policies we can assume that these prices are in fact largely determined outside New Zealand on world markets. Inflation, however, can be assumed to be the outcome of domestic monetary policy: too rapid an expansion of the money supply will generate a high level of domestic demand causing imports to increase and weaken the balance of payments.

The third factor affecting the balance of payments is the exchange rate policy. By devaluing New Zealand can reduce the effect of domestic inflation on the balance of payments, but this can have little effect on the terms of trade, as illustrated

by the small relative trade price movements in 1975 and 1976 when the NZ dollar was devalued. Chart 2 sets out these three factors which affect the balance of payments. At the top of the chart the actual exchange rate is compared with a predicted exchange rate calculated by comparing price inflation in the US and New Zealand (i.e. a purchasing power parity analysis). The movement of the predicted exchange rate therefore mainly shows the likely effect on the balance of trade of the monetary policies pursued in New Zealand. If the dashed line is above the solid line the actual exchange rate is undervalued on a purchasing power parity basis and the trade balance can be expected to strengthen. Alternatively, if the dashed line falls below the exchange rate a subsequent deterioration in the balance of trade is likely.

At the bottom of the chart, the movements of export prices and import prices are shown. (Strictly, these are unit value indices.) If the gap between the export unit value index and the import unit value index widens, the balance of trade can be expected to strengthen while a narrowing of the gap leads to a deterioration. Using these indicators we can follow the recent economic developments in New Zealand and attempt to discover which factors have been important.

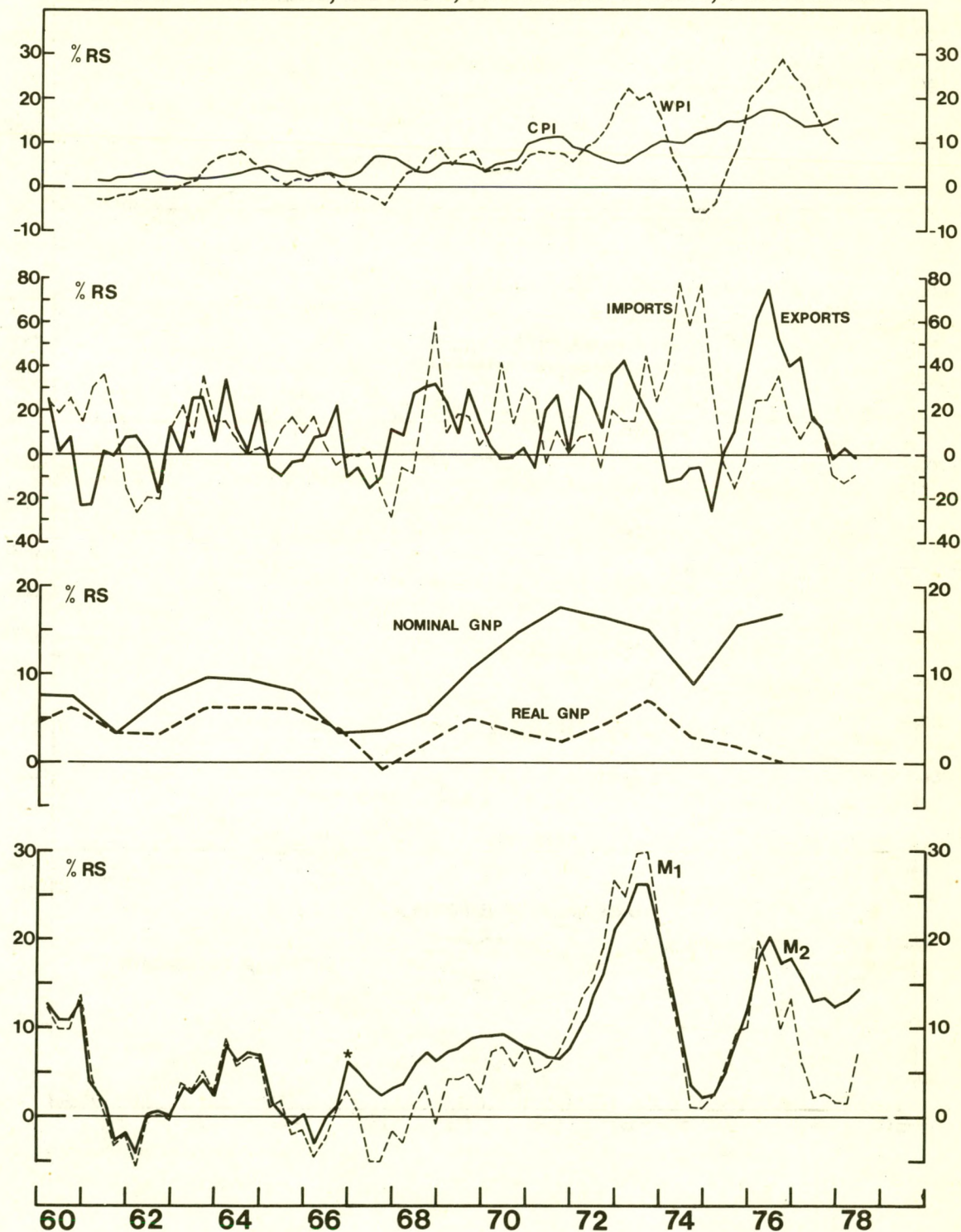
Until 1967 the import unit value index was very stable. New Zealand imports a broad range of goods including oil, so fluctuations in the price of any one good has little overall effect on the unit value index. Since the New Zealand pound was pegged to the US dollar and US prices were stable in this period, New Zealand's import prices stayed quite level until the devaluation of the pound in 1967. After 1967, inflation in the U.K., the US and other countries translated into a general rise in import prices.

The export unit value index by contrast has been more erratic. This instability is due to the fact that New Zealand is dependent for nearly 60% of its export receipts on only three commodity groups- meat, dairy products and wool - whose world prices are quite volatile. In the early sixties the export unit value index typically moved 20% between the troughs and peaks of the US business cycle. These large movements imposed a pronounced cyclical variation on foreign earnings, on the money supply and on domestic activity. Nevertheless from the late fifties until 1967 New Zealand did not have any serious balance of payments problems and it is fair to say that the cyclical movements overlaid a fundamentally stable trend in the balance of payments.

If we assume therefore that the New Zealand pound was at an 'equilibrium' parity during this period, we can assess the subsequent movements in the exchange rate and the balance of payments using a purchasing power parity analysis. From the top of Chart 2, it is clear that the New Zealand pound was fundamentally undervalued after it devalued with the pound sterling in 1967. This theory is supported by the fact that the trade balance tended to strengthen in the late sixties. No doubt partly as a consequence of the balance of payments surpluses, the money supply (see Chart 1) accelerated reaching a peak rate

NEW ZEALAND

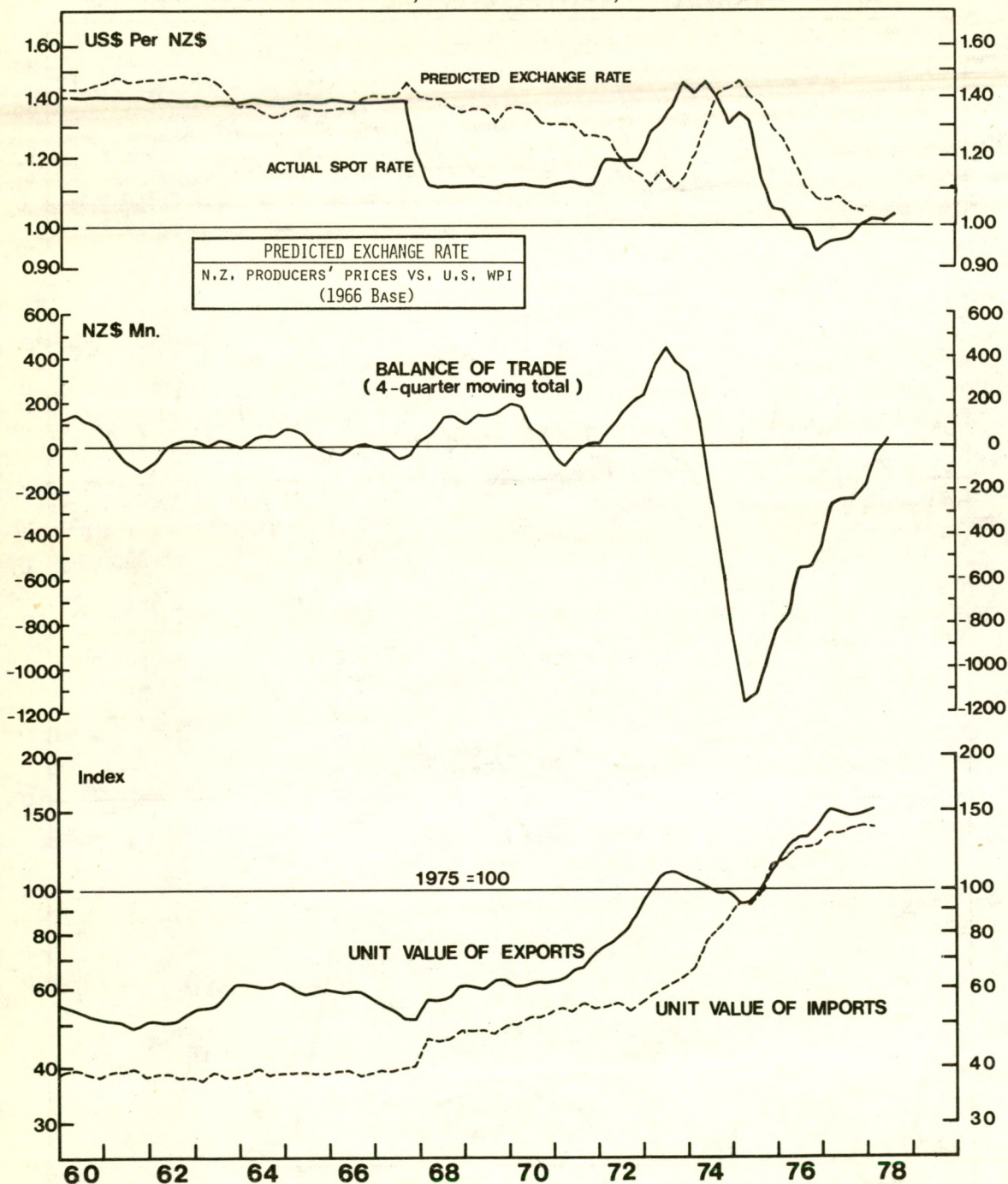
CHART 1 : MONEY, OUTPUT, EXTERNAL TRADE, AND PRICES



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* Change of data series.

NEW ZEALAND
CHART 2 : EXCHANGE RATE, EXTERNAL TRADE, AND TRADE UNIT VALUES



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of over 9% per annum in early 1970. Wholesale prices and consumer prices peaked the following year, causing the inflation differential between New Zealand and the United States to be eroded considerably. The New Zealand dollar no longer looked so undervalued.

In 1972 and 1973 the rapidly growing trade surplus can be attributed to the terms of trade, as can be seen from the bottom of the chart. Export prices rose more rapidly than import prices. In 1973 inflation in New Zealand tended to weaken the trade balance but the world wide commodity boom overshadowed this deterioration and kept the balance of trade firmly in the black until 1974. After the oil crisis, the terms of trade collapsed as can be seen from the convergence of the unit value indices, and New Zealand's balance of trade plunged deeply into deficit. The large trade deficit was probably also partly due to the delayed effects of the deterioration in relative inflation rates observed in the previous year.

In 1975 the New Zealand government decided to follow an expansionary monetary policy to stimulate economic activity. Essentially their approach was to use one problem to solve another. They hoped to use inflation to counteract the deflationary effects of the turn in the terms of trade. The only lasting solution to a change in the terms of trade is to allow the distribution of resources and the pattern of demand in the economy to adapt to the new price structure. That is, the government should allow or even encourage the development of industries and other activities which use less of the high priced imports, produce import substitutes or produce exported goods more efficiently. A policy of monetary expansion does little to help this process, indeed the anti-inflationary wages and prices policies which the government imposed to keep the consequent inflation in check only served to disrupt the changes in relative prices which had to occur to bring about the necessary reallocation of resources. The result of the reflation policy was to attenuate inflation and delay the improvement in the balance of payments. Whereas most developed countries experienced their peak rates of inflation in 1974 and reached the bottom of the recession in early 1975, New Zealand's inflation rate did not peak until the second quarter of 1976 and real GDP growth slowed steadily from 1974 onwards until it virtually stagnated in the year ending March 1977 (Chart 1).

From Chart 2 it appears that after the large devaluations following the oil crisis (the NZ dollar fell 33.5% relative to the US dollar between the end of 1973 and the end of 1976), the currency was again undervalued on a purchasing power parity basis. The dashed line was once again above the solid line at the top of the chart. Because of this undervaluation a rapid improvement in the trade balance could be expected if the terms of trade remained stable. This improvement did in fact occur and by the end of 1977 the trade balance had returned to surplus. The terms of trade have also improved slightly since the oil

crisis and this further helped the situation.

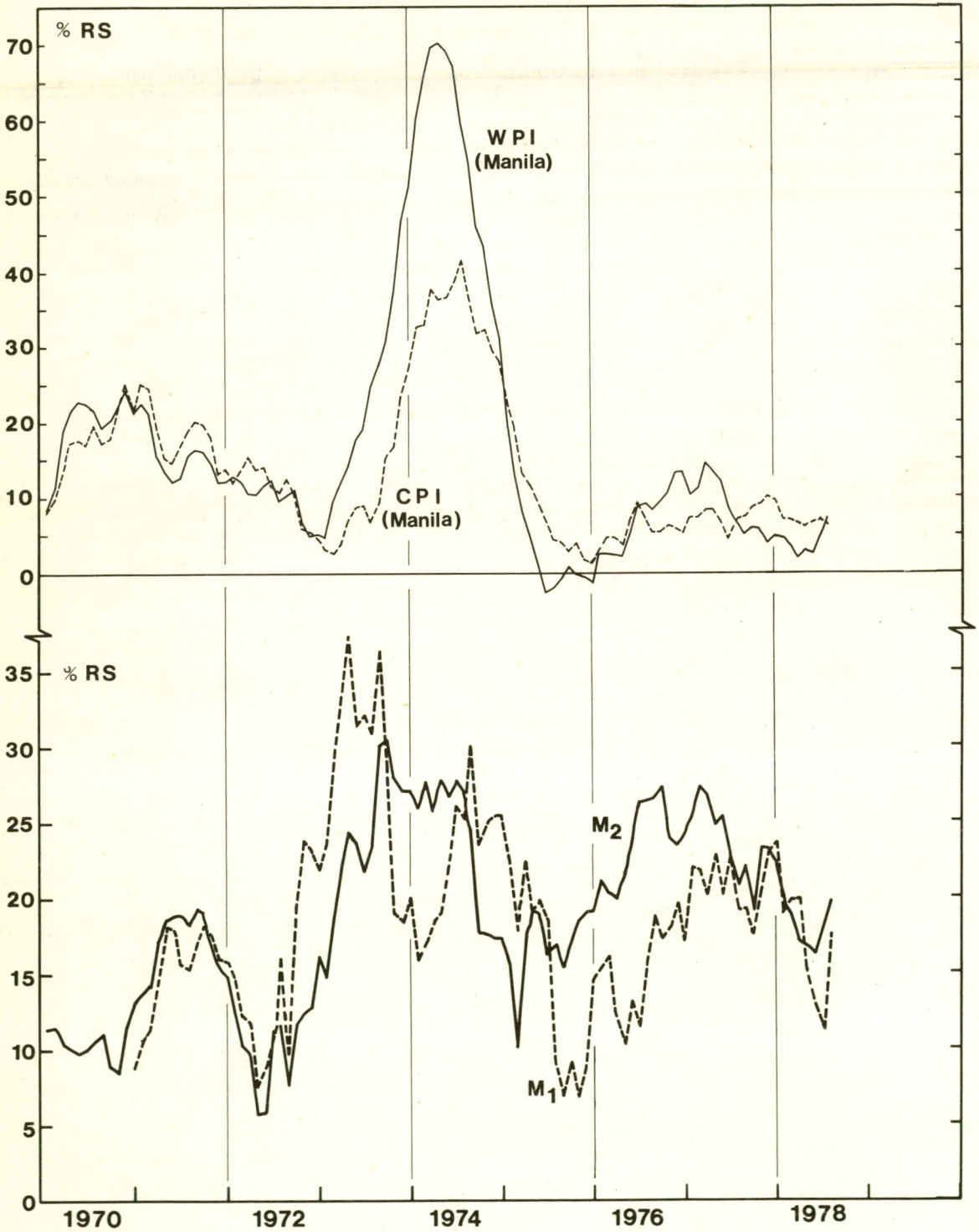
The inflationary policy did however remain a serious hindrance to recovery of equilibrium because it meant that the purchasing power parity advantage obtained through devaluation was quickly eroded away. At the top of chart 2 it can be seen that the predicted exchange rate plunged down with the actual exchange rate at such a fast pace that devaluations had to be repeated to maintain New Zealand's competitive position. If monetary policy had been restrained, such a large fall in the exchange rate would not have been necessary to restore the balance of trade.

Inevitably since inflation accelerated year after year from 1972 to 1976, inflationary expectations have now been built up in New Zealand to an extent which makes a subsequent reduction in inflation painful and difficult. Since 1976 the government has attempted to restrain monetary growth but it appears that they have been rather infirm of purpose. Following the slowdown in monetary growth in 1976 which brought M_3 growth down to 12% per year by the end of 1977, economic activity stagnated and unemployment soared. In reaction to these developments the Reserve Bank eased monetary policy early this year and monetary growth has reaccelerated. M_3 in July was up 17% compared with a year earlier, and the revival in business activity was becoming apparent by the middle of the year. The monetary authorities changed tack again in August when Mr. Muldoon in his capacity as Minister of Finance announced a tightening of monetary policy once more. The Government cash loan offered on the 21st of August was offered at higher rates than the previous loan and Treasury bill rates were also raised. In addition reserve requirements on trading banks' time deposits have also been increased. Unlike Australia, which has steadfastly pursued a policy of slow monetary growth since 1976, New Zealand's intermittent attempts at restraint have been mild. The relaxation of monetary policy since the beginning of this year may have induced a temporary recovery in business activity, but it has undoubtedly hindered the fight against inflation and it has certainly not helped the balance of payments. Whereas Australia is experiencing a falling rate of inflation New Zealand's consumer prices continue to rise at double digit rates. Moreover if M_3 continues to grow at around 17% per annum there is little prospect of any decline in the rate of inflation in the near future.

As the Reserve Bank acknowledges, regulation of monetary aggregates in New Zealand is hampered by both the very large public sector debt and the volatile trade balance which have serious effects on the monetary base. In recent years the Bank has had difficulty trying to sell government securities to the non-bank private sector because of uncompetitive interest rates. In the light of this, the recent moves to develop a more flexible interest rate structure are welcome and should make monetary control easier in the future.

FORECAST: Unless the New Zealand authorities make a determined and persistent attempt to reduce the rate of monetary expansion, inflation will continue at a high rate and the improvement in the balance of payments will be thrown away. From our purchasing power parity analysis it appears that no further improvement in the trade balance deriving from an undervalued exchange rate can be expected this year. This is because inflation has now completely eroded the competitive advantage obtained by the devaluations of 1975 and 1976. Only a sudden improvement in the terms of trade or a pick up in the volume of exports can be expected to improve the balance of payments. Large changes in these areas are unlikely so further improvement in the balance of payments figures will be slow. Though the trade figures are again in the black, the current account remains in deficit because of the very large deficit on invisibles. For this reason overseas borrowing by the government has been necessary and will continue to be necessary to maintain the current exchange rate without reducing the foreign reserves. The recent tightening of monetary policy means that interest rates in New Zealand will probably be tight until early 1979. If the monetary restraint continues and is significantly more restrained than the previous attempt at tightening in 1976-77 inflation may slow down later in 1979 but by how much depends on the actions of the monetary authorities. Such a decline in inflation would be accompanied by a decline in domestic business activity.

PHILIPPINES
CHART 1 : MONEY AND PRICES



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PHILIPPINES

A PERSISTENT TRADE DEFICIT

Developing countries which are heavily dependent on commodities and raw materials naturally have a keen interest in world prices of these items. In 1974 with the surge in commodity prices on a worldwide scale, 4 commodities - sugar, copper, coconut oil (copra) and logs - accounted for no less than 69% of the export earnings of the Philippines. But last year, following the prolonged slump in sugar and copper prices, the earnings of these same commodities amounted to only 51% of the Philippines' total export earnings. Parallel to the shift in the prices of these commodities there has also been a shift in the overall balance of payments.

In 1973 and 1974 the Philippines experienced an overall payments surplus of US\$664 million and \$110 million respectively and since this there have been deficits of \$521 million in 1975 and \$164 million in 1976, and a further deficit is projected for this year. (In 1977 there was actually a surplus of \$164 million - thanks in large part to borrowing from overseas). Numerous commentators and official spokesmen have implicitly or explicitly suggested that it only requires a general upturn in the prices of copper and sugar for the external payments position of the Philippines to be reversed. To what extent is this true?

Chart 1 opposite shows the pattern of Philippine exports and imports since 1970. Broadly speaking the trade account (exports less imports) was in approximate equilibrium from 1970 until 1973 when for a brief period a trade surplus emerged. Exports boomed, growing from around US\$100 million per month at the end of 1972 to almost \$180 million by mid-year, and then slackening off slightly towards year end, in a seasonal pattern that has become fairly typical. Imports, on the other hand lagged behind at first and only overtook exports in early 1974, continuing to rise to a peak later in that year several months after exports had begun to experience their seasonal downturn. Ever since 1974 the trade deficit has remained in place, widening to its maximum in late 1975 or early 1976. At present there is no sign that the gap is about to close, and one must ask whether in fact all of the explanation is to be found in the relative deterioration of the Philippines' terms of trade - i.e. the greater relative decline of Philippine export prices as compared with her import prices.

The upper part of the chart provides some of the explanation. The line showing the index of adjusted relative prices compares wholesale prices in the Philippines with wholesale prices in the United States, adjusted for changes in the peso/dollar exchange rate. Following the devaluation of the peso in February 1970 it is assumed that prices in the two countries were properly aligned by the first quarter of 1971. Thereafter any movements of the index above unity suggest that prices are too low in the United States while shifts below unity are indicative of prices being too high in the United States. When the level of prices in the Philippines is higher than the level of prices elsewhere, consumers and businessmen

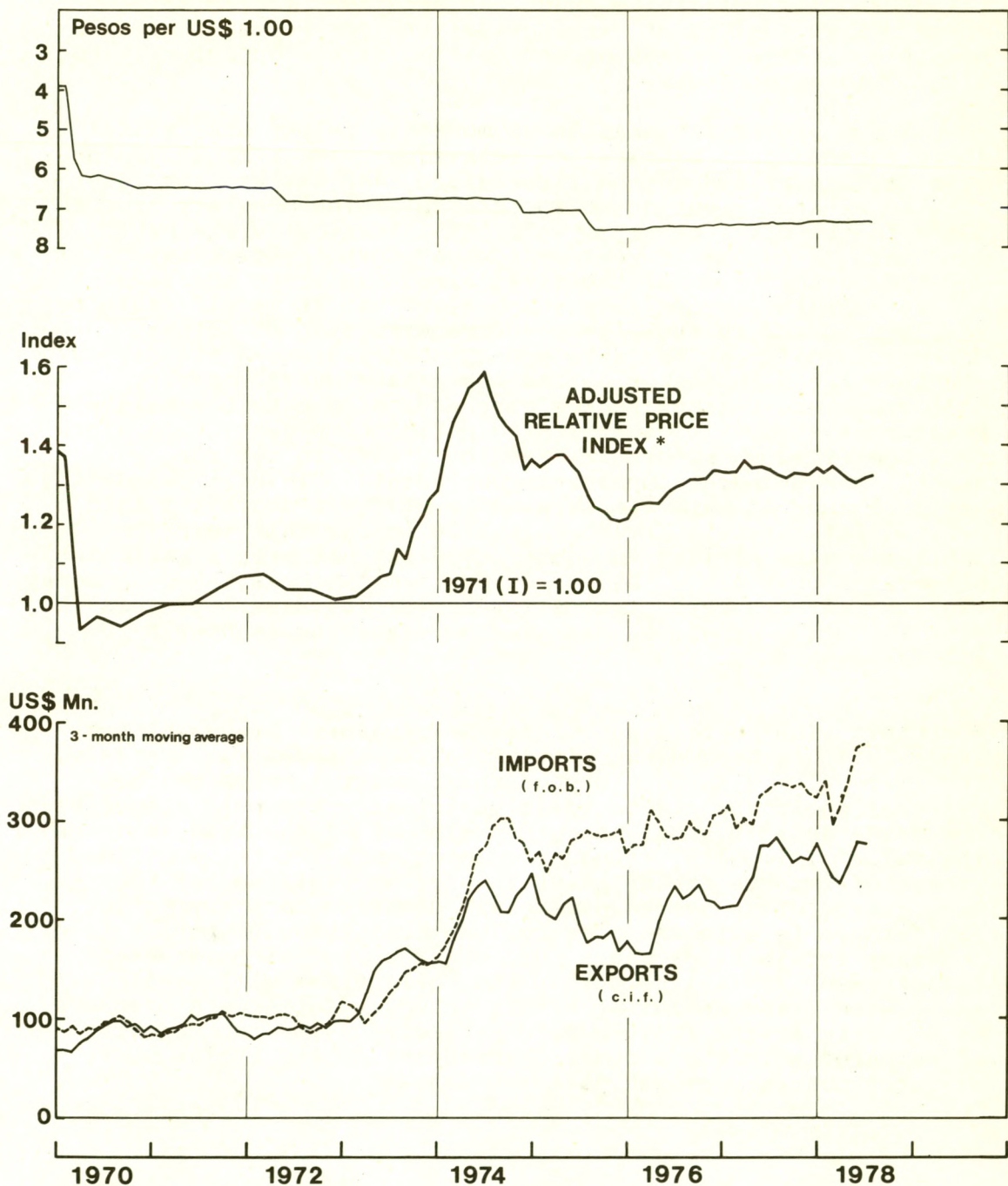
can be expected either to choose foreign products in preference to domestic manufacturers' goods, or to buy more goods (and services) from foreigners than they otherwise would. The rise of the adjusted relative price index since 1973 would seem to give a good initial explanation of the shift from surplus to deficit, and of the continuation of the deficit. Thus in order to return to approximate equilibrium in the trade accounts it appears necessary either for domestic Philippine prices to be lowered, or for US prices to rise, or for the peso to be devalued vis-a-vis the dollar, or for some combination of these events to occur.

Since 1973 there have been two small downward adjustments in the value of the peso, one towards the end of 1974, and another in mid-1975, but since then the peso has been held roughly stable in the ₱7.30-7.50 per US\$ range. Interestingly, Philippine inflation in 1973-74 was much more severe than that experienced in the U.S., but also much more short-lived. As a result, relative prices in the Philippines were already falling by 1974 - i.e. even without a devaluation of the peso, Philippine export prices were already falling in late 1974 and continued through 1975. Nevertheless, despite the two further depreciations, the relative level of prices in the Philippines has remained about 30% too high (based on wholesale price indices). As a result imports have continued to be attractively priced and the value of imports has consistently stayed ahead of the value of exports. Why has the internal price level not been adjusted to correct the trade imbalance?

The answer is to be found in the conduct of monetary policy. (Charts 2 and 3). Chart 2 shows that monetary policy was highly expansionary through 1976 and 1977, but has gradually tightened up during 1978. The broadly-defined money supply M_2 grew by 24.3% in the year ending December 1976, and continued to grow at a rapid 22.4% in the following year to December 1977. Since then there was some deceleration to 16.4% as of May 1978, and M_1 slowed even more sharply to 11.5% in June. The monetary deceleration if sustained should contribute in the months ahead to reducing the incipient inflationary pressures which have been such a concern to the authorities through the early months of this year. The rise in domestic prices of such items as soap, oil, milk and coconut-based products has been a persistent source of friction between the government and consumer groups on the one hand and producers or retailers on the other. For a time price controls were enforced to suppress the symptoms of inflation, but so far as the trade balance is concerned there has been very little effect. Central Bank statistics reveal that imports of "non-essential" luxury consumer items have continued to rise.

Some commentators, puzzled by the inflation and tending only to look at the most recent statistics for M_1 , have attributed the continuing upward pressure on prices to the OBUs (Offshore Banking Units), claiming that they provide an independent source of inflation through causing an excessive increase in the money supply and thereby inflating the demand for goods and services. This possibility could not be discounted if OBUs were issuing large quantities of peso

PHILIPPINES
CHART 2 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



* Philippine prices vs. U.S. prices adjusted for exchange rate changes.

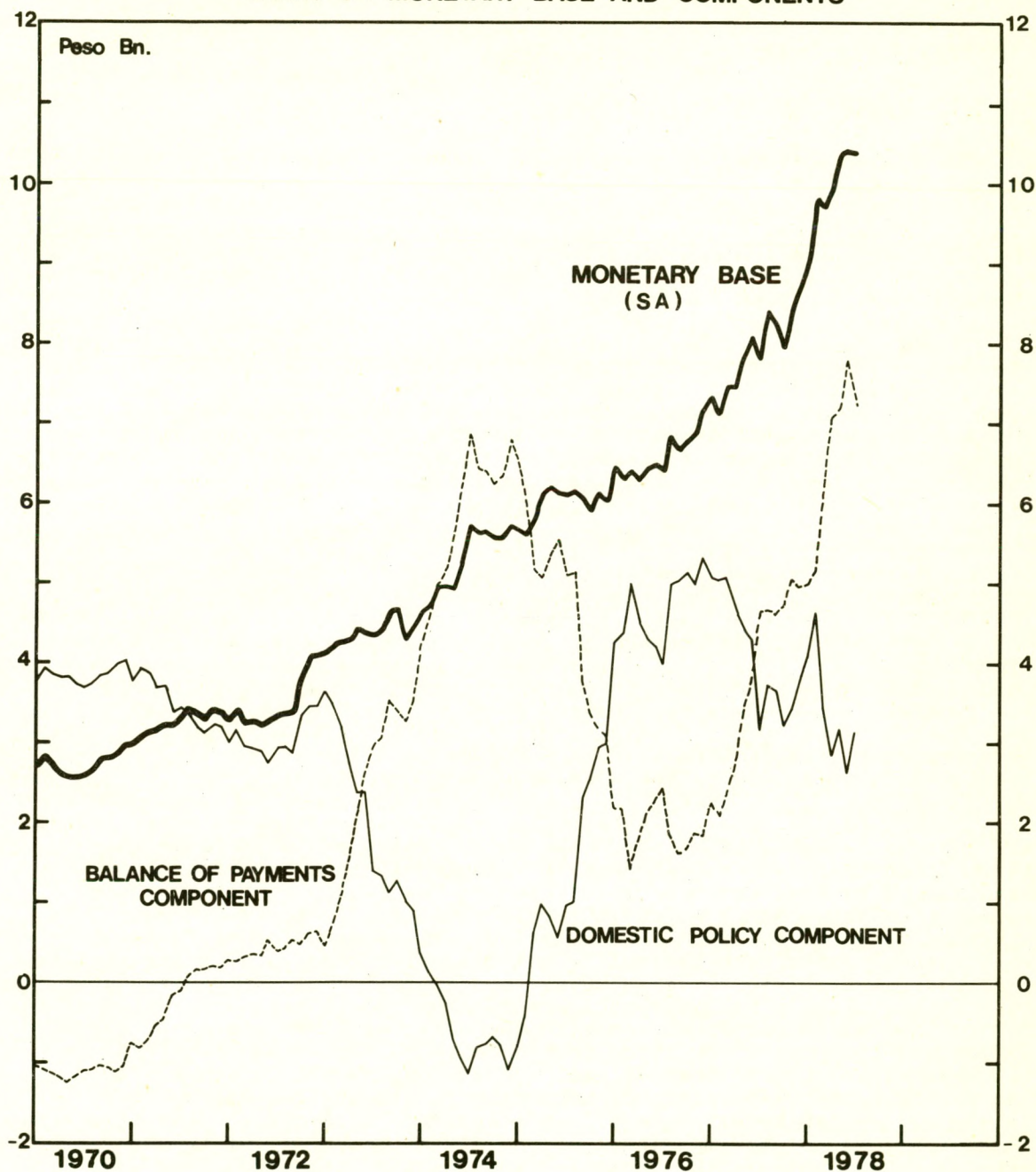
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liabilities, but in fact OBUs are restricted to foreign currency (primarily US\$) business, so that in order to inflate the demand for Philippine goods and services, owners of these claims must first exchange dollars for pesos, thereby depriving another person or corporation of the opportunity to bid for local products.

For a proper explanation of monetary policy and inflation it is necessary to examine the relations between money, output, velocity and prices in the first place, and, at another level the factors contributing to the growth of the monetary base and hence to the money supply itself. The lack of sufficiently good data on output in real or nominal terms prevent any detailed examination of the first area, and there are several problems in the second area which mean that it is difficult to have confidence in the likely future direction of policy. However, insofar as the data permit, Chart 3 shows that in 1975 and 1976 the main factor behind the expansionary monetary policy was the Central Bank's purchases of domestic - mainly government - securities (domestic policy component), and since 1977 the primary factor has been the growth in net foreign assets (the balance of payments component). In other words the small balance of payments surplus in 1977 was converted into a substantial expansionary force, while so far this year the contractionary element in domestic policy has been significantly offset, in both cases, by borrowing from overseas. Recent money supply figures suggest that after the slowdown earlier this year the money supply M_2 was once more growing at nearly 20% per annum by July,

FORECAST: The performance of the Philippines' trade balance since 1974 has been disappointing to the authorities. Mostly they have blamed factors beyond their control, such as the price of their exports in world markets for the persistence of the trade deficit. But the other element of the trade balance, the value of imports, is equally important, and the continued growth of imports can at least in part be explained by the maintenance of an over-expansionary domestic monetary policy. Until there is evidence of a real determination to pursue lower monetary growth rates and a sufficient period of enforcement has elapsed, it is likely that the Philippines will continue to experience trade deficits, with a tendency for upward pressure on domestic prices and downward pressure on the exchange rate as compared with the stronger currencies of the region where stricter monetary growth policies prevail.

PHILIPPINES
CHART 3 : MONETARY BASE AND COMPONENTS



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EPISODES FROM ASIAN MONETARY HISTORY

CHINA AND THE SILVER STANDARD : Part 2

THE LAST YEARS (1914 - 1935).

This is the second of two articles about the experience of China on the silver standard.

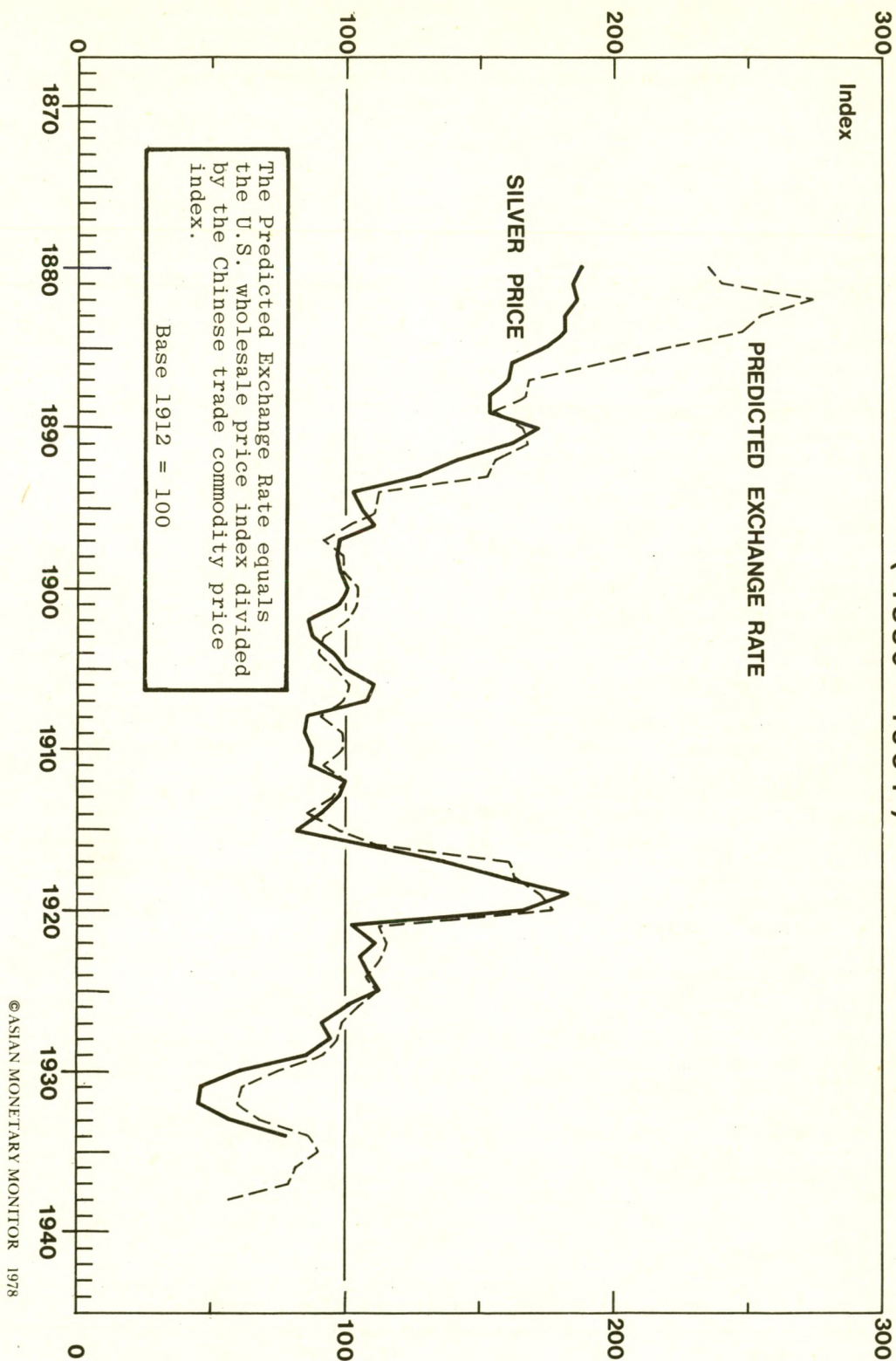
By the outbreak of the First World War China was the only major country that still adhered to the silver standard. There were two major reasons for her anomalous position: one was her extreme backwardness, the other was her weak government.

Though various proposals for currency reform had been put forward in the last years of the Manchu dynasty, the feeble and corrupt administration lacked the motivation to undertake sweeping changes. To centralize the issue of currency and to ensure moreover that the official currency was accepted by the populous would have required considerable administrative competence and a degree of financial respectability which the government conspicuously lacked. The peasantry and landlords had a justified distrust of banknotes and demand payment in weights of copper or silver. To complicate matters, silver was minted throughout China and most provincial banks issued their own notes. Though gradually more and more standard silver dollars came into circulation, other forms of silver coinage were abundant and traders still resorted to weighing and testing the silver they used. Whereas India under a British administration was able to adopt a sterling-exchange standard (i.e. effectively a gold standard) in 1897 through official control over the minting of Rupees, China was incapable of doing this. The lack of any substantial gold reserves was a secondary problem and gold coinage was emphatically not necessary for the adoption of a sterling exchange standard, as is clearly illustrated by the fact that India's Rupees remained silver long after her abandonment of the silver standard.

The essential requirement for the abandonment of the silver standard was instead the ability to raise the market value of the coinage above the bullion value so that the market value could then be pegged to a gold standard. This required the restriction of the supply of mint coinage relative to the demand, which in turn necessitated government control over the issue of coinage in circulation. It is doubtful whether the weak Chinese government had sufficient financial resolve to restrain its own minting activities, and such was the reputation of the government that it is unlikely that the public were prepared to pay any premium at all to have their silver minted with the official mark. In other words, as long as the people continued to negotiate contracts and settle debts in terms of weights of pure silver, and as long as all coin was judged not according to face value but according to its bullion value, there was little hope of abandoning the silver standard. In contrast, the notes and coins of foreign institutions did at times circulate at a premium. Most notably the banknotes and cheques on the Hongkong and Shanghai Bank fetched substantial premiums to face value in the 1920s because the reputation of the bank was held in such high regard.

In the 1920s the increasing use of standardized coins and notes brought about the conditions whereby the currency came to be accepted at face rather than intrinsic value, and the coinage itself, rather than merely its bullion content, was accepted as money. Further progress towards reform was made with the establishment of the Central Bank of China in 1928, but the issue of banknotes remained in private hands until after the silver standard was abandoned. In the event the silver standard broke down when the foreign price of silver rocketed which had the effect of virtually draining China of silver currency.

CHART 1
CHINA
THE PRICE OF SILVER IN THE US AND THE PREDICTED EXCHANGE RATE
(1880 - 1934)



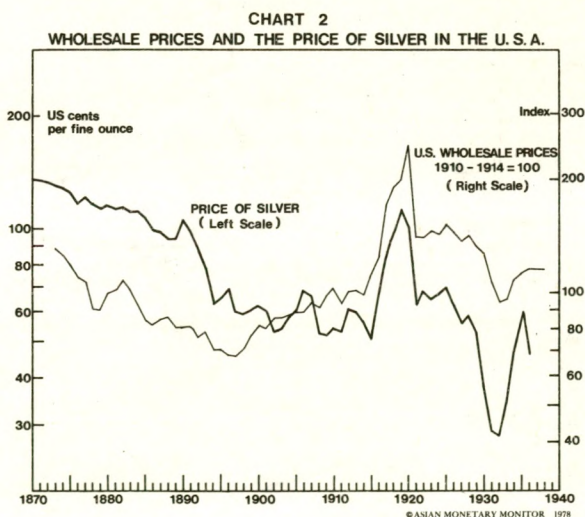
To summarize, the Chinese remained on a silver standard long after most of the trading world had adopted gold essentially because its weak government lacked the motivation, the ability and the authority to reform the chaotic currency system. However, the silver standard did have an advantage: because the price of silver rose and fell relative to gold, the exchange rate of the Chinese currency relative to gold standard currencies was flexible. Whereas the U.S. and the U.K. were bound together in a monetary union by the fixed exchange rate between their currencies, and prices and interest rates in the two countries therefore had to move roughly in step, by contrast, Chinese prices and interest rates were determined by the price of silver and at times followed a markedly different path. Fortunately for China, the silver price tended to move in line with other commodity prices in the gold standard countries; when commodity prices in terms of gold fell the price of silver also fell, keeping prices in terms of silver roughly stable. This automatic price stabilizing mechanism was very rough and ready, and at times China suffered from sudden inflation or deflation if the price of silver moved out of line with other prices, but generally speaking, the automatic mechanism worked in such a way that China was insulated from the major booms and slumps which swept through gold standard countries.

For reasons outlined in the previous article, underlying the cyclical business cycle fluctuations in the price of silver was a secular decline in the price. Even though prices in China were insulated from the cyclical changes in prices experienced elsewhere, the long run decline in the price of silver relative to the prices of other goods caused a persistent but gentle inflation in China (see Chart 2).

In many ways the final two decades of the silver standard are the most remarkable in the history of this anomalous monetary system. From the outbreak of the First World War to the final abandonment of the silver standard in 1935 was a period of economic turmoil throughout the world. The Great War Inflation was followed by a severe postwar recession and then a long period in which the United States prospered but other gold standard countries, the U.K. and Europe - struggled to regain the power and prosperity of the pre-war years. In 1929 the Great Depression hit the United States and in the following years it drew every gold standard country into a severe deflation. How did China fare in these two decades of worldwide inflations and deflations?

The First World War

During the First World War Britain suspended the free exchange of silver and the United States also imposed restriction on its use. These restrictions were imposed because the demand for the metal by the authorities was very high. During the war the United Kingdom bought a considerable amount of goods -especially textiles for uniforms- from the Far East for which the oriental exporters demanded payment in silver so the British government had an urgent need to acquire the metal. An embargo was placed on the private shipment of silver from England so that all silver could be used for official purchases. At the same time Britain arranged with the United States to buy silver from the US



reserves and the US government withdrew silver certificates from circulation. As worldwide demand for the metal soared, the price of silver advanced by leaps and bounds, but the rise in the silver price took place against a background of general inflation in gold standard countries, so the price of silver relative to other goods changed much less.

On the eve of the declaration of war the price of silver in London was about 25 pence per ounce. In the following year the price remained around the same level, but in 1916 the price rose to over 30 pence as inflation accelerated. Even so, the price of silver lagged behind prices in general causing the purchasing power of silver to decline in the U.K. Between 1914 and 1918 the price of silver rose only 88% compared with a 125% rise in wholesale prices in general, a difference of 35 percentage points. Between 1914 and 1920 - the height of the war time boom - prices tripled in Britain and doubled in the United States. Other countries which attempted to keep to the gold standard experienced similar inflations.

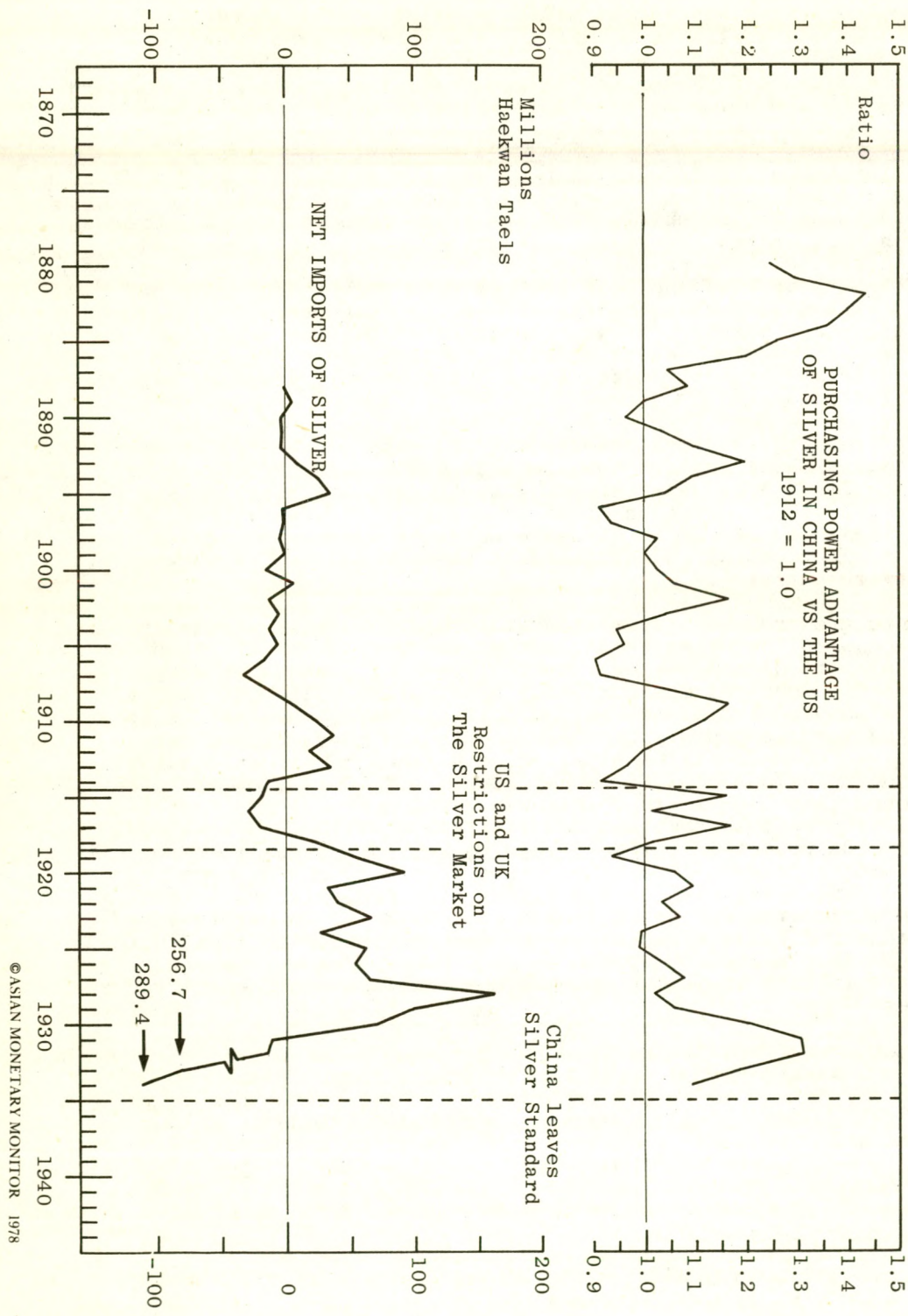
Perhaps surprisingly, despite all the supposed silver payments for war purchases, China appears to have been a net exporter of silver during the First World War according to the customs reports (see Chart 3). Moreover, wholesale price in China appear to have been virtually stable between 1914 and 1918. The evidence does not therefore suggest that China was experiencing an inflationary boom, regardless of whether her exports were thriving.

There are probably two reasons for this. Firstly, trade in bullion between the Orient and the West was very probably disrupted by the war efforts of the western powers. Secondly, the soaring price of silver removed most of the competitive advantage China may have had. Because Japan and India were on the gold standard, when prices in the west began to rise rapidly Japanese and Indian goods became very competitive: both countries experienced balance of payments surpluses and rapid expansions of their money supplies.* China, on the other hand, found that her exchange rate was going up nearly as fast as prices in the west so that she had little competitive advantage. Whereas trade prices in terms of gold rocketted, prices in terms of silver hardly changed. China remained insulated and uncompetitive. Hong Kong, which was also on the silver standard, also reportedly suffered during the war years from a lacklustre trade performance. Undoubtedly China did miss out on the boom but she also avoided the inflation. Her neighbour, Japan on gold did not escape as can be seen from Chart 4 which shows the movements in wholesale prices in the two countries.

* The experiences of India during the war are notable. Having closed the silver mints in 1893 and formally adopted the gold exchange standard in 1897 she found herself *de facto* back on a silver standard in 1916. The reason was that the rocketting silver price pushed the bullion value of the rupee above the official sterling - exchange value. To prevent the coinage being demonetized and melted down to be hoarded or exported the authorities were forced to revalue the rupee in line with the silver price. The rupee exchange rate rose from 1s.4d. in 1916, to 1s.8d. in May 1919, then in a series of rapid steps the rupee was forced up to 2s.4d. which it reached on 16th December, 1919.

Silver however could only push one way, and, though the price of silver dropped like a stone in 1920 the official rupee rate remained pegged (though now in terms of gold rather than sterling which had in effect left the gold-standard) with the result that the rupee again became a fiat currency and India was back on the gold standard.

CHART 3
CHINA
THE NET IMPORTS OF SILVER UNDER THE SILVER STANDARD
(1887 - 1934)



Around the end of the war the tables turned and China began to become very competitive. As the upward march of the price of silver slowed and inflation continued unabated in the West the purchasing power of silver in China began to compare favourably with its purchasing power in the US. Silver began to trickle back into China in 1918, the trickle became a flood in the following two years and wholesale prices began to rise. China prospered virtually uninterrupted from then till 1930.

The last years of the Silver Standard 1920-1935

In 1920 the price of silver reached 61.50 pence in London. The economic boom in the Gold Standard world came to an abrupt end and the United States experienced one of the sharpest recessions in history. Wholesale prices dropped 40% in under a year, and following the pattern already observed, the price of silver fell just as far and its purchasing power remained unchanged. In the United Kingdom silver fell relatively further so that the purchasing power of the metal declined from 77.8 to 75.4 (1910-1914=100). The remarkable stability in the purchasing power of silver in the US and the U.K. was reflected in relatively insignificant change in prices in China during the recession. Once again China was insulated.

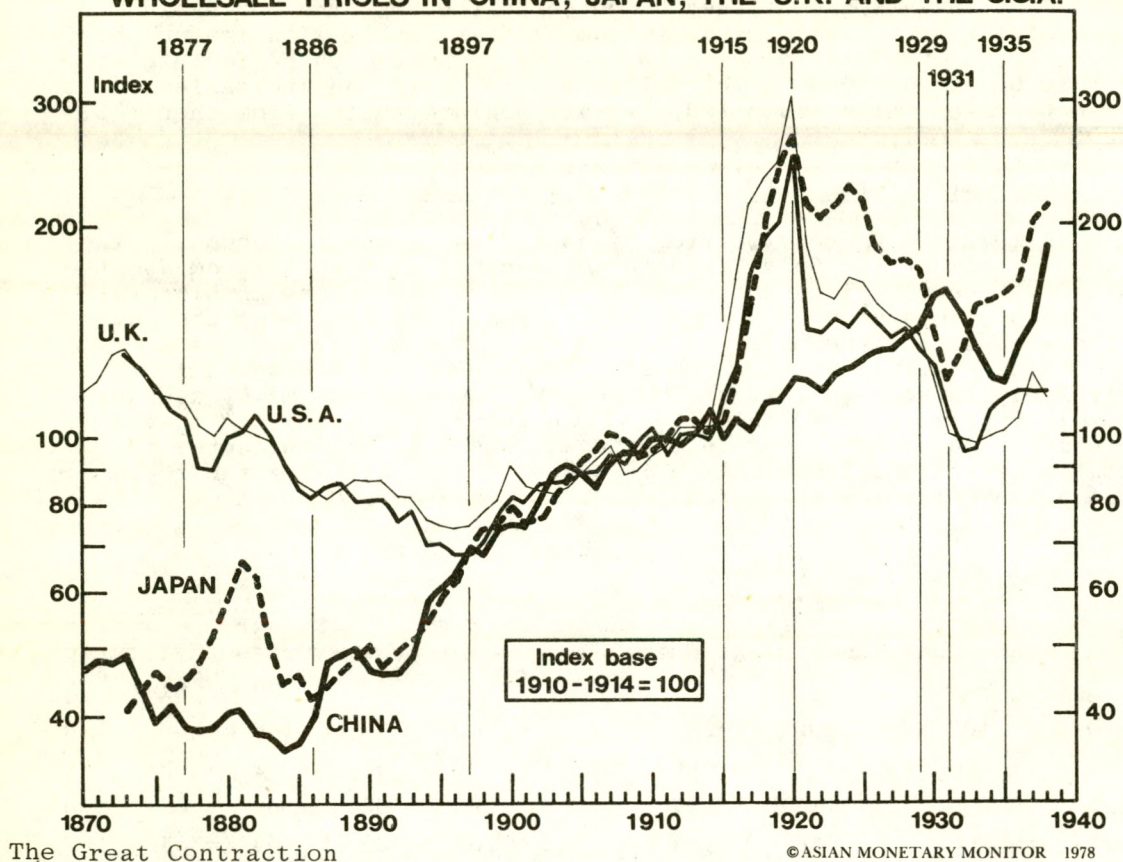
Wholesale Prices in China, the US and the UK

	Shanghai	Canton	N. China	Trade WPI	US		UK	
					WPI	Silver price	WPI	Silver price
1919	-	-	91	92	89	109	81	93
1920	100	100	100	100	100	100	100	100
1921	99	106	100	100	63	62	62	60
1922	96	111	97	96	62	66	52	56
1923	103	116	101	101	65	64	51	52

In the United States at least, the recession was brief and business recovered rapidly but wholesale prices remained flat and silver tumbled unevenly downwards in price throughout the 1920s, with the result that China benefited from a persistent purchasing power parity advantage. Because the domestic cost/price structure and patterns of trade inevitably lagged the decline in the silver price, the exchange rate quoted for the Haikwan Tael was usually at a small premium to silver, making the importation of silver into China again profitable. A steady influx of the metal in the early twenties provided a gentle and persistent stimulus to commerce. The volume of imports, after rising sharply between 1920 and 1922, remained high in the following years reflecting the prosperity of the commercial towns. Wholesale prices advanced steadily year after year.

The booming economy of China in the 1920s is worth contrasting with the severe deflations experienced in Japan and the U.K. Both countries felt a strong commitment to the gold standard. During the Great War both Japan and Britain had experienced an inflation which had made their price levels incompatible with the USA at the prewar gold parities of their currencies. In other words, both countries could only hope to achieve balance of payments equilibrium by altering their price levels through devaluation relative to the US dollar or by domestic deflation. Japan exhausted virtually her entire foreign reserves in trying to maintain an inappropriate parity, while the UK undertook a vicious deflation of her economy to reduce her domestic price level. Both countries therefore suffered from chronic difficulties throughout the 1920s. Britain regained her old gold parity in 1926 and Japan returned to the gold standard a few years later.

CHART 4
WHOLESALE PRICES IN CHINA, JAPAN, THE U.K. AND THE U.S.A.



In 1929 when the US went into recession, wholesale prices in New York began to fall. Once again China was saved by the silver standard. The New York price of silver tumbled from 53 cents in 1928 down to 28 cents in 1933, but this fall outstripped prices in general so that prices in terms of silver again effectively rose during a recession. Again, China became extremely competitive and silver flowed across her borders. In late 1929 the recession began to bite in North America and it got deeper through 1930 and on into 1931. The effects spread like shockwaves throughout the gold standard world. The monetary contraction in the United States bled Europe of gold and the United Kingdom, France and Germany were drawn into the whirlpool.

While Europe and America were experiencing monetary contractions China experienced a rapid monetary expansion. The Chinese money supply (M_1) rose by 17% in 1929 and by a further 37.8% in 1930; wholesale prices followed suit. In 1930 wholesale prices in Shanghai rose 7.7% and by August 1931 they were up 8.9% on a year earlier. China's experience was in stark contrast to that of the US and the UK where in 1930 wholesale prices plunged 15% and 18% respectively. Never was there a clearer example of the economic independence of nations afforded by flexible exchange rates.

Because her exchange rate fell further and faster than world prices in general, China's exports remained very competitive enabling her to expand her share of world trade and thereby substantially to offset the decline in world trade as a whole. The fall in the volume of China's exports was thus comparatively mild, and the silver value of her exports fell even less, because prices in terms of silver were still rising. Though it is clear that the silver value of Chinese exports peaked in

1929 when global prosperity combined with the falling price of silver gave China the best of both worlds, even so her exports declined only gently in the following two years, and China's export trade did not suffer the drastic cutbacks experienced in European countries.

A similar picture is given by imports. The volume of imports declined from 1928 till 1931, but the silver prices of imports rose. The net result was a sharp increase in China's import bill. Consider for instance China's trade with the US;

In millions of Haekwan Taels	Chinese Exports to the US	Chinese Imports from the US
1927	122	167
1928	127	206
1929	138	231
1930	132	232
1931	120	321
1932	60	269
1933	73	191
1934	61	174

Notice how both exports and imports remained high until 1931 and thereafter collapsed.

The inflation up to 1931 was not without its problems. Pinnick writing in China in 1930 bemoaned the effects of inflation on those who lived on fixed incomes, the harmful effects on creditors and the disincentive to save. Property speculation was rampant. All these phenomena are familiar today, but they were remarkable in 1930 considering the contemporary world-wide depression.* The benefits of the inflation as always were not distributed uniformly. The commercial centres particularly Shanghai and Canton benefited more than the interior because they were in a position to take advantage of the differential between domestic prices and foreign prices. Exports of textiles were sold at world market prices which were still rising in terms of silver, while labour costs and materials reflected domestic prices which lagged behind. As a result owners of cotton factories and shipyards in Shanghai gained considerably, while rural areas suffered. The few articles farmers bought from the towns rose in price considerably more than the grain they produced; some indication of this is given by movements in wholesale price indexes. Between 1926 and early 1931 the prices of metals in Shanghai had risen over 60%, fuel and lighting had risen over 40%, building materials had risen over 30% and textile products over 20%. Cereals on the other hand had not risen at all. (Admittedly, in the intervening period cereals had at one time risen in price by over 20% (in 1930) but this was probably due to shortages and for most of 1928, 1929 and 1931 Cereal prices were on average lower than in 1926.)

There were also great differences between provinces. In Canton Province between 1926 and 1930 wages rose 57%, while prices did not rise at all. Hankow and Wuchang on the other hand both experienced price rises of 110% while wages rose only 18% and 7% respectively. These enormous differences of experience emphasise the difficulty of treating China at this time as one economic region; the considerable barriers to trade and communication within China meant that when one region was prosperous another might be at the brink of starvation. While there is clear evidence that Shanghai was thriving in 1930 and 1931 little can be said about the vast areas of rural China where feudal subsistence rather than commercial trade prevailed.

* 'Silver and China' Pinnick. Shanghai 1930.

For the Shanghai business community the party came to an end in September 1931. In that month there were two major events which were to have serious consequences for China: the more immediately relevant was the Japanese invasion of Manchuria, the second was Britain's decision to go off the gold standard. The first was to precipitate the degeneration of the political situation and the second began the monetary and fiscal deterioration of the country.

Britain left the gold standard in order to halt the rapid depletion of her gold stock. In effect the Bank of England no longer stood ready to redeem sterling at a fixed parity in gold. Instead traders were obliged to obtain foreign currency on the exchanges at whatever rate they could get with the result that there was an immediate devaluation of sterling in terms of the US dollar, the French Franc and all other gold standard currencies. Prices in Britain were thereby suddenly reduced in terms of gold and the country's competitive position was somewhat restored. The effect on Britain of devaluation was similar to the effect the fall in the price of silver had had on China. At a stroke Britain had cut herself off from the deflationary monetary union with the United States. Henceforth the US money supply contraction would have more effect on the exchange rate and less on the UK monetary base. Immediately wholesale prices in the UK stabilized: after having fallen 14.4% in the 12 months before the gold standard was abandoned, wholesale prices rose 2.8% in the following 12 months, while in the US the depression got deeper and wholesale prices were dragged down a further 8.3%.

The effect of Britain and, soon after, Japan leaving the gold standard was to reduce the extent to which China's currency was undervalued relative to her trading partners. China was no longer virtually the only place cheaper than the US. As one by one other countries abandoned the gold standard the price of silver and hence the Yuan* exchange rate rose in those countries.

The Price of Silver

per ounce	in New York in cents	in London in pence	
1929 June	84.4	84.5	
Dec.	78.9	78.2	
1930 June	54.9	55.5	
Dec.	52.1	52.9	
1931 June	42.9	43.2	
July	45.1	45.8	
Aug.	44.3	44.6	
Sept.	44.9	45.3	
-----			Britain leaves gold.
Oct.	47.9	60.1	
Nov.	50.1	65.8	
Dec.	48.1	69.7	
1932 June	44.5	58.8	
Dec.	40.4	59.6	
1933 June	58.2	66.6	
Dec.	70.0	64.9	

From being an astonishingly weak currency the Chinese silver dollar almost overnight became unfortunately strong. The currency initially traded at a reduced premium to silver and then even at a discount, so the export of silver became profitable. The banks in Shanghai suddenly found that their silver reserves were being drained away causing a severe credit squeeze. Call money rates jumped from 7 cents per \$1000 per day in July to 37 cents in November and by December the money supply was down 10.8% on a year earlier. The property market collapsed and wholesale prices tottered and then fell. By December 1931 China was well on the way to joining the rest of the world in the Great Depression.

* The Yuan or silver dollar became the most common form of silver currency in the 20th century.

In April of the following year upward pressure on the exchange rate eased as international exchange markets stabilized and the price of silver softened in New York, but the respite was only brief and by August the trade weighted effective exchange rate was resuming its upward march. The forced appreciation of the Yuan relative to the currencies of China's major trading partners had serious effects on the balance of payments. Both gold and silver left the country in 1932 and 1933 in amounts far outweighing the net capital inflows. China was experiencing steady deflation through the balance of payments. Business in Shanghai was depressed and wholesale prices fell steadily. In the two years from December 1931 to December 1933 wholesale prices in Shanghai fell 19.2%. Interest rates after the initial squeeze sank back as loan demand stagnated.

The London Silver Agreement 1933

After more than fifty years of secular decline and a dramatic final plunge between 1929 and 1931, the price of silver in New York stabilized at around 28 cents per fine ounce for over two years. In London silver had even risen substantially. It was this very halt to the steady fall in silver which was the cause of China's recession: for years Chinese prices had been adjusting to a depreciating currency, now the process was being reversed. The currency was rising and prices were falling. Thus when delegates from the major silver producing and consuming countries convened in London in July 1933 with the expressed intention of 'doing something for silver', they were nearly two years too late. The price of silver had already stopped falling. The USA - which produced about 25% of the world's newly mined silver - naturally dominated the meeting and had a strong interest in seeing the price of silver go up. US silver mines found it difficult to break even at the prevailing price, and southern farmers believed that the increased monetary use of silver would expand the money supply and thereby stimulate the economy. The US, Australia, Canada, India, Mexico, Peru, Spain and China signed the London Silver Agreement on July 22, 1933 under which, among other things, they agreed not to debase silver coinage any further and to endeavour to substitute silver coinage for low denomination paper currency. In particular India undertook to sell no more than a fixed amount of silver on world markets. These measures attempted to increase the coinage demand for silver while reducing the supply of silver and therefore tended to raise the price. The prospect of a further effective appreciation for her currency did not appeal to China but she was reluctantly persuaded to sign, and, as expected, the price of silver and hence the Yuan strengthened in New York.

The silver lobby in the United States was still not satisfied and on December 21, 1933 the President of the United States issued a proclamation ratifying the London Silver Agreement and announcing that for four years starting January 1, 1934 the United States Government would buy just over 24 million ounces of silver per year at a price of 64.5 cents/oz. As the market price at that time was only 43.5 cents the government purchases were to provide substantial support to the price. In June the following year the Silver Purchase Act was passed by Congress. The main points of the Act were as follows:

- 1) The president was permitted to nationalize all silver in the US.
- 2) The Secretary of the Treasury could purchase silver at home or abroad at any rates, terms or occasions he wished. Purchases were to be made at 50 cents per ounce for all domestic silver stocks held on May 1, 1934.
- 3) Payment for the silver was to be made by issuing silver certificates - but these were to be offset by retiring Federal reserve notes.

In August the government began to nationalize silver. The Chinese government sent protestations to the United States pointing out the disastrous effect of such action on the Chinese economy, but to no avail. What started as a commodity price support programme led to a tripling of the price of silver between early 1933 and mid 1935, and a world wide abandonment of the monetary use of silver.

The Chinese exchange rate which had fallen from a premium of 3.6% on the price of silver in 1930 to a discount of 0.1% in 1933 plunged to a discount of 6.9% against a soaring silver price in 1934. The profits to be had from the export of silver from China were extremely high, and traders promptly moved in.

Net exports of Silver from China, 1931-35.

Net Exports of Silver In millions of dollars		Balance of Payments Deficit
1931	- 70.3	166.8
1932	+ 10.4	266.0
1933	+ 14.2	386.2
1934	+279.9	397.3
1935	+289.4	360.0

The Shanghai banks were not the worst hit at first. Silver was withdrawn from the interior to the coastal cities prior to export, so the net outflow from the Shanghai banks was not serious. Then, as the supply of silver from the interior waned and silver exports continued to grow the credit squeeze began in Shanghai. The government imposed an export tax on silver in October 1934 but it was powerless to stop smuggling. It was clear that unless the government acted quickly China would experience a rocketting exchange rate, an enormous current balance of payments deficit and the loss of virtually all her silver currency leading to a phenomenal deflation.

The End of the Silver Standard

On October 14, 1934, the Central Bank of China announced that henceforth there would be an exchange equilization charge between the London silver price and the price of the Chinese Yuan. The effect of this interim measure was to devalue the Chinese currency relative to the foreign silver price. In 1935 the Yuan exchange rate was fixed in terms of dollars at a rate which was equivalent to a 20% depreciation in the external value of the currency and was 40% below the ruling silver price. Prior to this abandonment of the silver standard, the amount of silver coinage in circulation had already been declining relative to the amount of bank notes under the operation of Gresham's Law, so the adoption of what was essentially a paper standard was not a complete revolution. Nevertheless, by removing the necessity of maintaining a silver reserve against the issue of notes, the authorities removed a major constraint on the expansion of the money supply. In order to prevent inflation it was vital to be able to impose rigorous control on the issuance of banknotes. To some extent this was achieved. By 1936 the right of note issue was limited to four banks: the Central Bank, the Bank of China, the Bank of Communications and the Farmers' Bank. That was as far as the reforms went. Plans to place the reserves of the turmoil after the outbreak of the Japanese war in 1937. The Central Bank in any case was under the control of the Kuomintang government, which used its control to finance its expenditure from the note issue.

With the government itself intent upon printing money, inflation was the inevitable result. From 1935 onwards inflation accelerated almost without a pause until the final collapse of the Kuomintang government in 1949.

In retrospect it is clear that the silver standard had protected China not only from deflation overseas but also from domestically generated hyperinflation. Though contemporary commentators had almost universally criticised the silver standard for causing wild fluctuations of the foreign exchange rate and for generating a persistent inflation, compared with what followed on the 'paper' standard the years of silver were relatively calm and prosperous.

The period of the Chinese hyperinflation was covered in three articles in Asian Monetary Monitor Vol. 1 No.1, No.2 and No.3.

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JAPANESE OCCUPATION CURRENCIES(3)

According to Colin Narbeth, author of the book "Collecting Paper Money", Malayan paper money was printed in such large quantities by the Japanese that until the late 1960s complete sets from 1 cent to 1000 dollars were being offered for sale for as little as US\$9.00. A Swedish firm, presumably anxious to raise the market value of its inventory of these notes, advertised them in journals: "Light your cigar with a 1000 dollar note." The 'Banana' notes of Malaya - so named because of the bunch of bananas hanging from a banana tree in a popular denomination of the note, were not only issued by the Japanese, but also by the British for propaganda purposes. On the reverse side the inscription, carried in Malayan, Burmese, and Chinese, contained the following message: "At present in Malaya, Japanese money is no longer recognised and the original notes are the only legal tender, when the British return to Malaya, their notes will be used as before. The Japanese notes will disappear together with the Japanese, forever, but the original British money will continue to be used."



A one hundred rupee note used in Burma during the Japanese occupation.

Addendum

Page 38 para. 4 line 19 should read:

'Plans to place the reserves of the commercial banks with the Central Bank were abandoned in the turmoil after the outbreak of the Japanese war in 1937.'



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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

THE IMPACT OF THE US ECONOMY ON THE S.E. ASIAN REGION

It is often pointed out, correctly, that South East Asian trade is becoming less dependent on the United States. Trade within the region and particularly with Japan has grown tremendously in the past decade. Because of this general diversification of trade, so the argument goes, the region has less to fear from a recession in the United States, than it had in the past. Though this conclusion is probably correct we believe the line of reasoning is only partial and misleading.

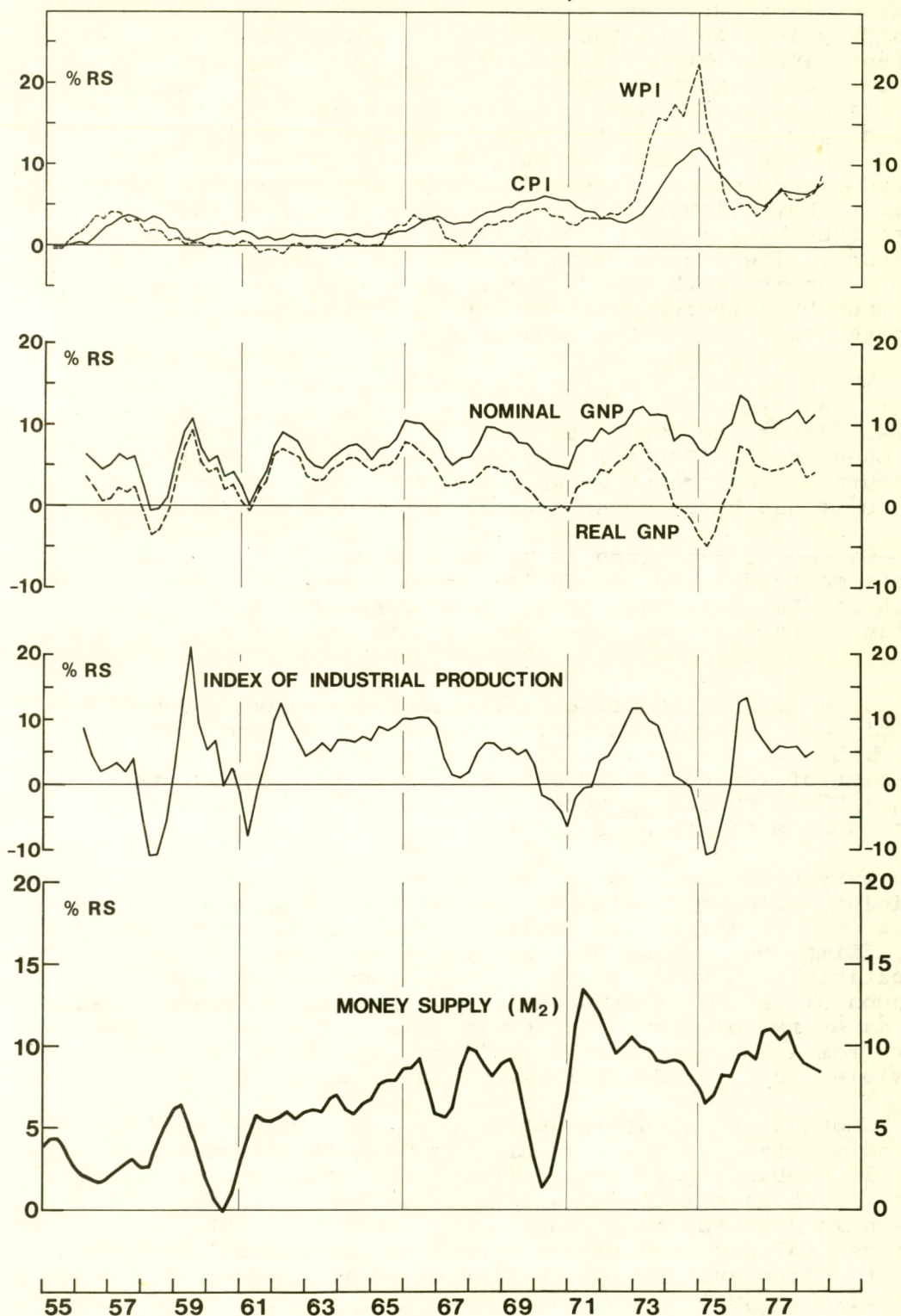
The US business cycle has two major effects on other nations. One effect is the direct and obvious impact on US demand for foreign goods, which directly affects the volume of business in those export industries which sell substantially to the US. The other effect is monetary and is potentially more far-reaching, exerting an influence on the value and volume of business in all sectors of the economy. For this reason it is not necessarily correct to argue that a country is insulated from the US business cycle merely because it exports relatively little to the United States.

The key to understanding the linkage between countries is the exchange rate policy, and the principles are best illustrated by the example of that often ignored country, Mangoland. Mangoland is a tropical archipelago in the South Pacific which is unusual in that she trades exclusively with Japan; she exports mangoes to Japan and imports Japanese colour televisions for her natives. For sentimental reasons (Mangoland is an ex-US colony) this idyllic Pacific island group pegs its currency the Frute to the US dollar. When the US dollar began to fall on the foreign exchanges in 1977 the Frute, being pegged, fell with it. Whereas the yen value of Mangoland's exports remained roughly stable the Frute value soared and Mangolian exporters became fat and prosperous. However, horrified by the soaring Frute price of colour TVs the natives' demand for imports began to decline and the balance of payments of Mangoland moved into surplus. The banks in the capital found their foreign reserves were rising so they remitted them to the central bank in exchange for Frute cash with which they could expand their loans. In due course Mangoland's money supply began to grow. The monetary expansion stimulated domestic demand throughout the islands and the stock and property markets enjoyed a flurry of speculative activity. Soon the inhabitants began to feel sufficiently wealthy to go back to buying Japanese televisions even at the new high prices and before long they were importing more than they were exporting. Mangoland like the United States was enjoying a boom, even though her only trading partner Japan experienced a mini-recession at the end of 1977.

Of course, with hindsight we can say that it had to come, but at the time few people would have confidently predicted that in 1979 the US President would appoint as principal

U. S. A.

CHART 1 : MONEY, OUTPUT, AND PRICES



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economic adviser an economist of the notorious 'monetarist' school of thinking. The subsequent severe monetary squeeze in the United States in late 1979 led to a marked recovery in the balance of payments and a strengthening of the dollar. Just when Mangoland was at the peak of its inflationary boom its currency appreciated rapidly with the dollar against the yen. The very high interest rates in the US attracted Mangolian investors to place their money in US dollar deposits. The sudden appreciation of the Frute relative to the yen also gave the Mangolians a price cut on their televisions and the natives rushed to buy more. Exchanging Frute for yen and dollars in order to buy televisions or take advantage of US interest rates, the Mangolians put the Frute exchange rate under pressure. The central bank in order to maintain the exchange rate at parity with the dollar sold foreign exchange for Frute and thereby withdrew Frute from circulation, causing a contraction of the Frute money supply.

The contraction of the money supply caused a tightening of credit and Frute interest rates rose along with US dollar rates. After the usual lag, domestic demand in Mangoland weakened and in 1980 the economy experienced a cyclical downturn. Even though Mangoland had no trade with the United States it had been forced to follow the US business cycle.

Of course Mangoland is an extreme case. Most countries have some trade with the United States and have central banks which are far less passive in their responses to foreign exchange transactions. The economic mechanisms are not usually as clear cut and are often obscured by special factors.

Even so, the countries which feel they have a commitment to maintain a particular dollar exchange rate are most vulnerable to the effects of US economic policy. It is the movement of the US dollar on the foreign exchanges rather than a US recession as such which has the most serious consequences for those countries.

Many countries attempt to follow independent monetary policies while continuing to peg their exchange rates to the US dollar. They may be successful at pursuing their own policies for a time, but unless by rare luck these policies are compatible with their exchange rates they will be forced to abandon either their exchange rates or their monetary policies. The major reason why countries in this region now have less to fear from a US recession is that they generally follow more flexible exchange rate policies than in the past.

Amongst the countries which peg, those which have tried to follow monetary policies relatively more expansionary than the US will probably suffer more from a strengthening dollar than those which have followed a more conservative policy. The reason is that the less expansionary countries will have rather stronger balance of payments positions and so will be better able to withstand an appreciation of their currencies. Australia is just such a case, having followed a tight monetary policy she can look forward to an improving balance of payments in 1979 even if the US dollar and the Australian dollar appreciate.

Table 1

Exports to the USA (in 1976) and current exchange rate policy

	As a percentage of Total Exports	As a percentage of GNP	Exchange Rate Policy
Hong Kong	29.1	24.7	Float
Singapore	14.7	16.7	Managed
Taiwan	37.2	16.5	Peg
Korea	32.3	11.3	Peg
Philippines	36.0	8.0	Peg
Malaysia	15.6	7.8	Managed
Indonesia	28.7	7.0	Peg
Japan	23.3	2.8	Float
Thailand	10.0	2.2	Managed
Australia	9.2	1.3	Managed

Korea on the other hand has followed a grossly inflationary policy and is already suffering from a serious balance of payments deficit: a strengthening Won would hurt her considerably.

Another interesting example is Thailand which approximates to the Mangoland position in that her major trading partner is Japan and the US buys only 10% of her exports. Like Mangoland, she virtually pegs her currency to the dollar. By following a relatively lax monetary policy Thailand has already generated balance of payments problems. Because of the close monetary link between the Baht and the dollar interest rates have been forced to move in line with US rates. A credit squeeze in the US and a strengthening of the dollar will therefore damage the Thai economy even though trade with the US is relatively unimportant.

In summary: for the economies of the South East Asian region the crucial question is not "Will the US have a recession?" but "Will the US dollar strengthen?"

The Outlook for the US dollar

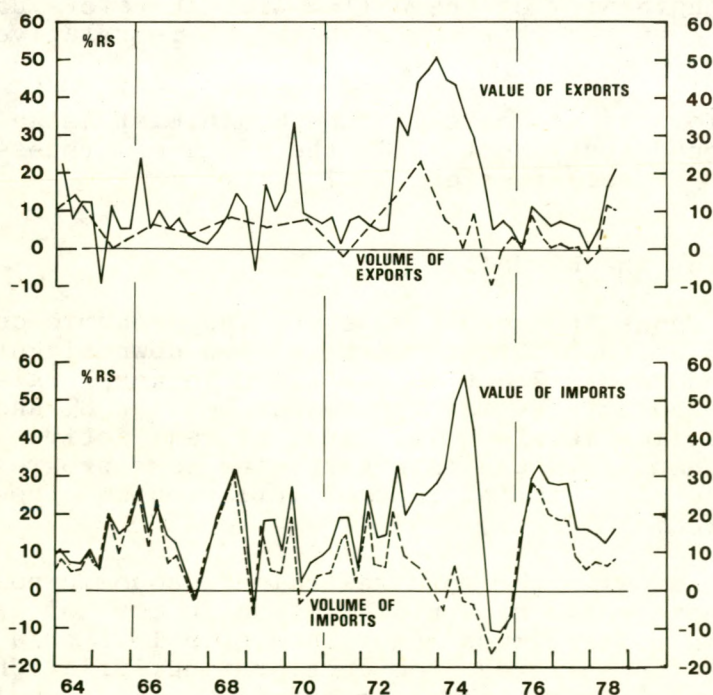
Chart 1 shows the recent monetary and economic developments in the United States. Growth in M_2 slowed down slightly towards the end of 1977 but M_1 continued to accelerate right through 1978 and both M_1 and M_2 are now between 8% and 9% above their year earlier levels. The level of real activity remained strong throughout 1978 and interest rates rose progressively reflecting the accelerating rate of inflation and the high demand for credit.

In contrast with the more restrained economic policies in Europe and Japan which brought inflation in most of these countries down to very much lower levels in 1978 than in 1977, the United States suffered from accelerating inflation. On a purchasing power parity basis alone the US dollar would be expected to weaken. The falling dollar also set in train the

course of events which will lead to an eventual restoration of equilibrium in the balance of payments. It is not widely realised that the US is currently enjoying a boom in exports. As Chart 2 shows, US exports have been growing rapidly since early 1978, no doubt at least partly in response to the falling dollar. If this trend continues the growth in exports will eventually more than compensate for the high growth in imports. However, if inflation in the United States continues to be higher than in Germany, other European countries and Japan, then the competitive advantage gained from the fall of the dollar will be eroded and a continuing depreciation of the dollar will be needed to continue the improvement in the balance of payments.

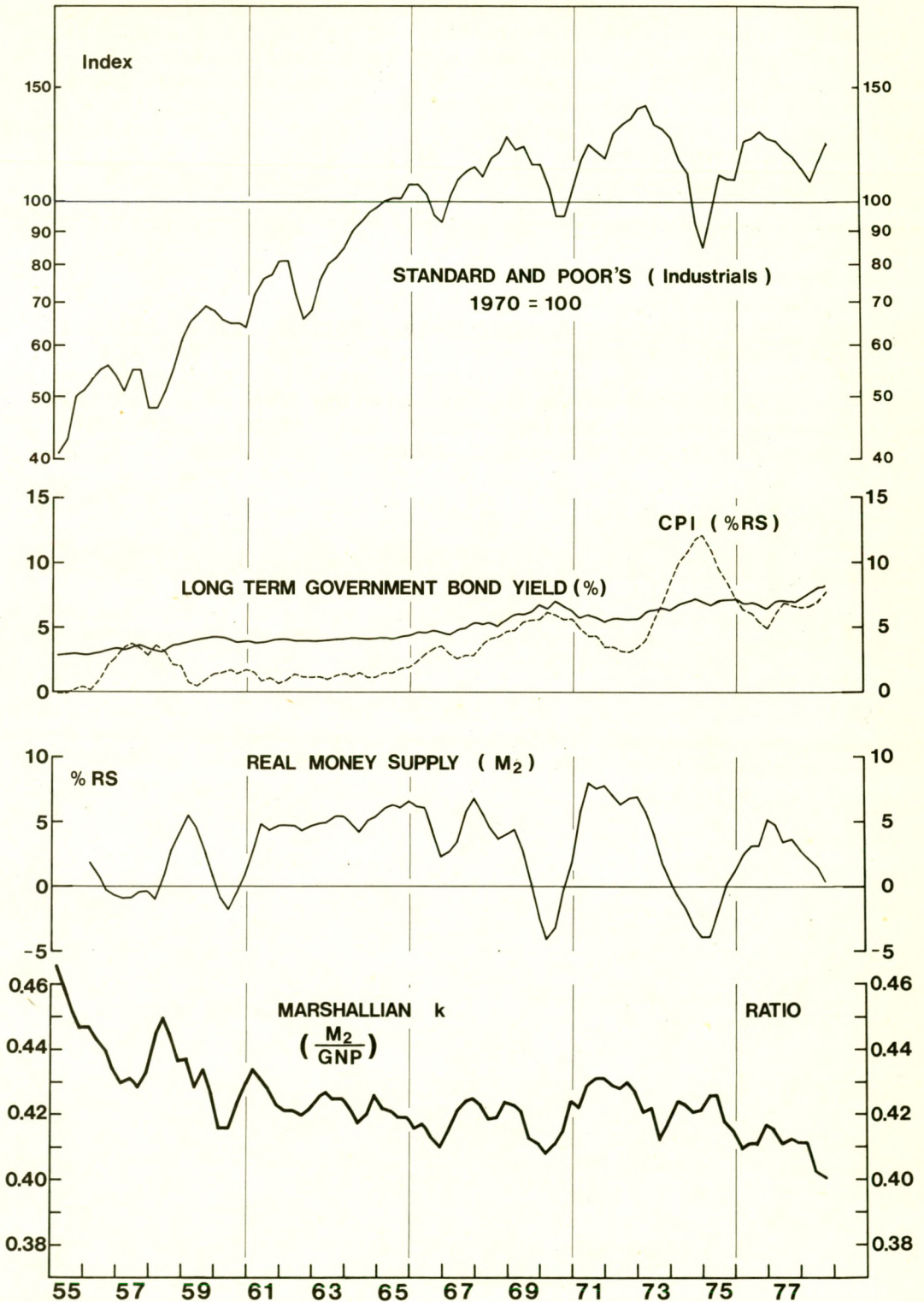
As popular and political pressure for an effective tight monetary policy grows, monetary growth may be curbed. If the experience of past business cycles is anything to go by, interest rates must rise to extreme heights in response to any substantive measures to curb monetary growth. In 1974 during the period in which prime rate was over 10% M_2 growth fell only from about 9.5% to 7.2% year-on-year. Given that rates of inflation in other countries are now very much lower than in 1974, monetary growth in the US must probably be squeezed much tighter than in the last cyclical recession in order to achieve a stabilization of the equilibrium exchange rate. Even though US interest rates are now very high, it cannot be taken for granted that the current restraint is sufficient to cause any significant slowdown in monetary growth. Interest rates have been rising merely to prevent monetary growth accelerating.

CHART 2 · US EXPORTS AND IMPORTS BY VOLUME AND VALUE



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CHART 3 : U. S. A. LIQUIDITY, INFLATION, AND STOCK PRICES



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It must be emphasised that a tight monetary policy must be followed (in the absence of reflation abroad) to stabilize the equilibrium exchange rate. We can define the equilibrium exchange rate loosely as that exchange rate which would maintain balance of payments equilibrium in the long run. In the shorter run the exchange rate can be significantly overvalued or undervalued relative to the equilibrium. If, as seems likely and as indicated by the rapid improvement in US exports, the US dollar is undervalued relative to the equilibrium rate there is scope for the US dollar to strengthen relative to the equilibrium rate. However, if the equilibrium rate itself is declining rapidly such an improvement may only be reflected in a stabilization or very slight appreciation of the spot rate.

FORECAST: For this reason even though further large falls in the dollar exchange rate against most major currencies are now unlikely, the dollar may still be weak for some considerable time. It is still too early to tell whether the US authorities have adopted a monetary policy sufficiently tight to prevent further weakness in the American currency.

AUSTRALIA

THE DANGERS OF OVERSHOOTING

In our last article on Australia in Asian Monetary Monitor Vol. 2 No. 3 we pointed out that an improvement in the balance of payments would lead to a resurgence of monetary growth if the authorities continued to peg the exchange rate. There is every indication that this has in fact happened. By September the seasonally adjusted monetary base had risen by 7.7% from the low it reached in February. Nearly 5.7 percentage points of that rise were due to the balance of payments effect.

The expansion of the monetary base was accompanied by an acceleration in the money supply. In the year to 31st October 1978, M_3 rose 10.3% compared with only 5% in the year to February. M_1 and M_2 show similar accelerations.

The combination of falling inflation and an acceleration in the money supply has provided some stimulus to the economy. At the bottom of Chart 2 the rate of growth of M_3 is shown, adjusted for the rate of inflation. Since the second quarter of 1978 the 'real' money supply has been growing at a positive rate for the first time since the Whitlam boom in fiscal 1975-76. In the past, movements in real M_3 have been roughly correlated with movements in the Sydney All Ordinaries Index. The surges in real money growth in 1962, 1966, 1972 and 1975 were all to varying degrees and with differing lags accompanied by bull markets. It looks as though 1978 has been no exception. Chart 1 shows that this bull market has been paralleled by some improvement in the trend of industrial production and real GNP.

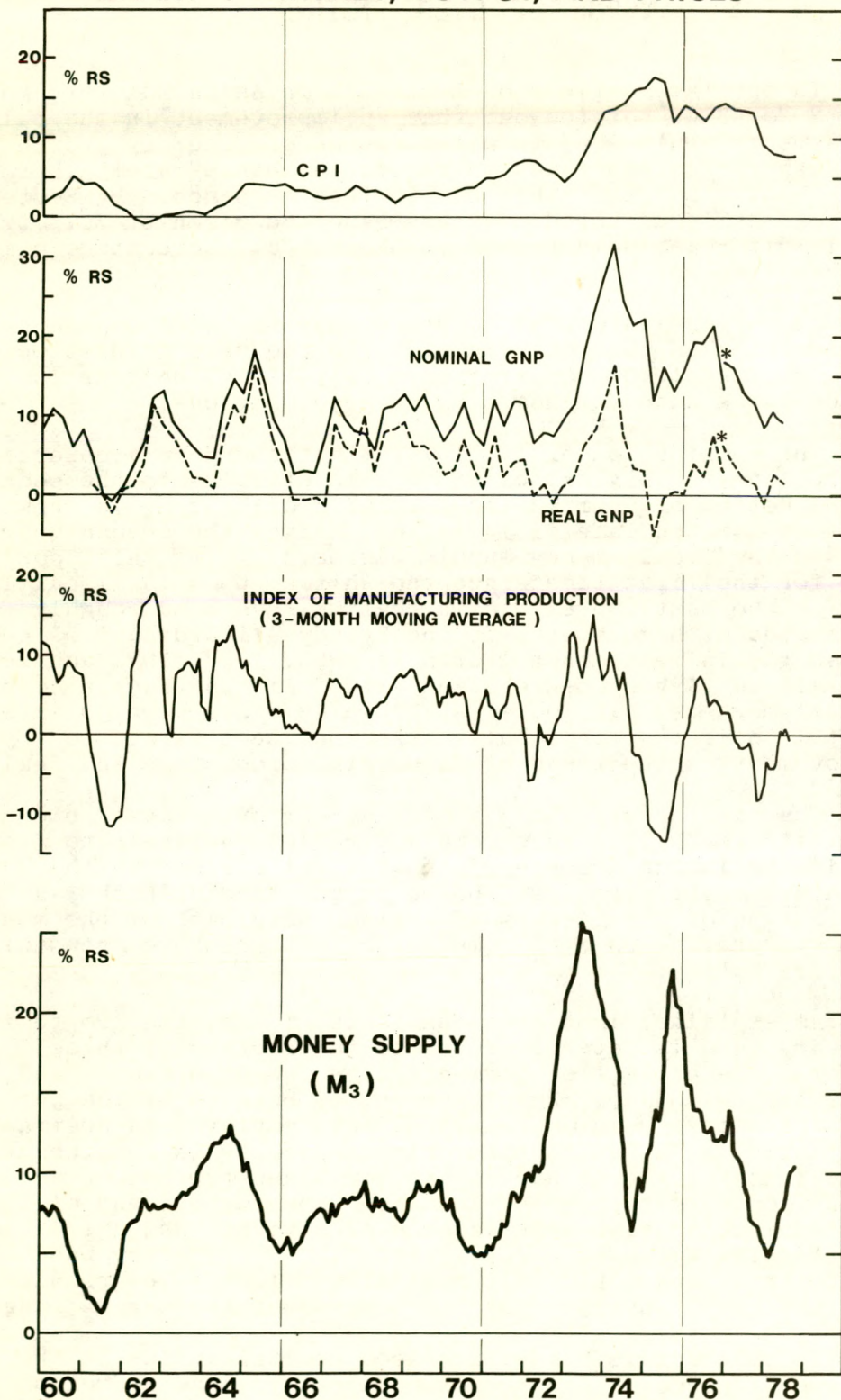
That is the situation as far as currently available statistics show. Is this monetary reflation likely to continue? In the absence of substantial changes in the statutory reserve ratios imposed on the trading banks, an examination of the factors affecting the growth of the monetary base can provide us with some guide to the future trend of monetary policy.

As explained in a previous issue of AMM, the growth in the monetary base is determined by the interaction of three factors, the balance of payments, the budget deficit, and central bank policy. Now in practice, because of the particular definition of eligible reserve assets employed in Australia, the central bank has considerable difficulty in counteracting the effects of the balance of payments and the budget deficit on the monetary base. For instance, towards the end of 1977 the combination of a weak balance of payments and a falling budget deficit caused a contraction in the monetary base which the central bank could only partially offset. The result was that the money supply tended to undershoot the target range.

In calendar 1978 the increased capital inflow on the balance of payments and the exceptionally large budget deficit in the second quarter have acted in the opposite direction as can be seen from Chart 3. The money supply M_3 - currently

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES

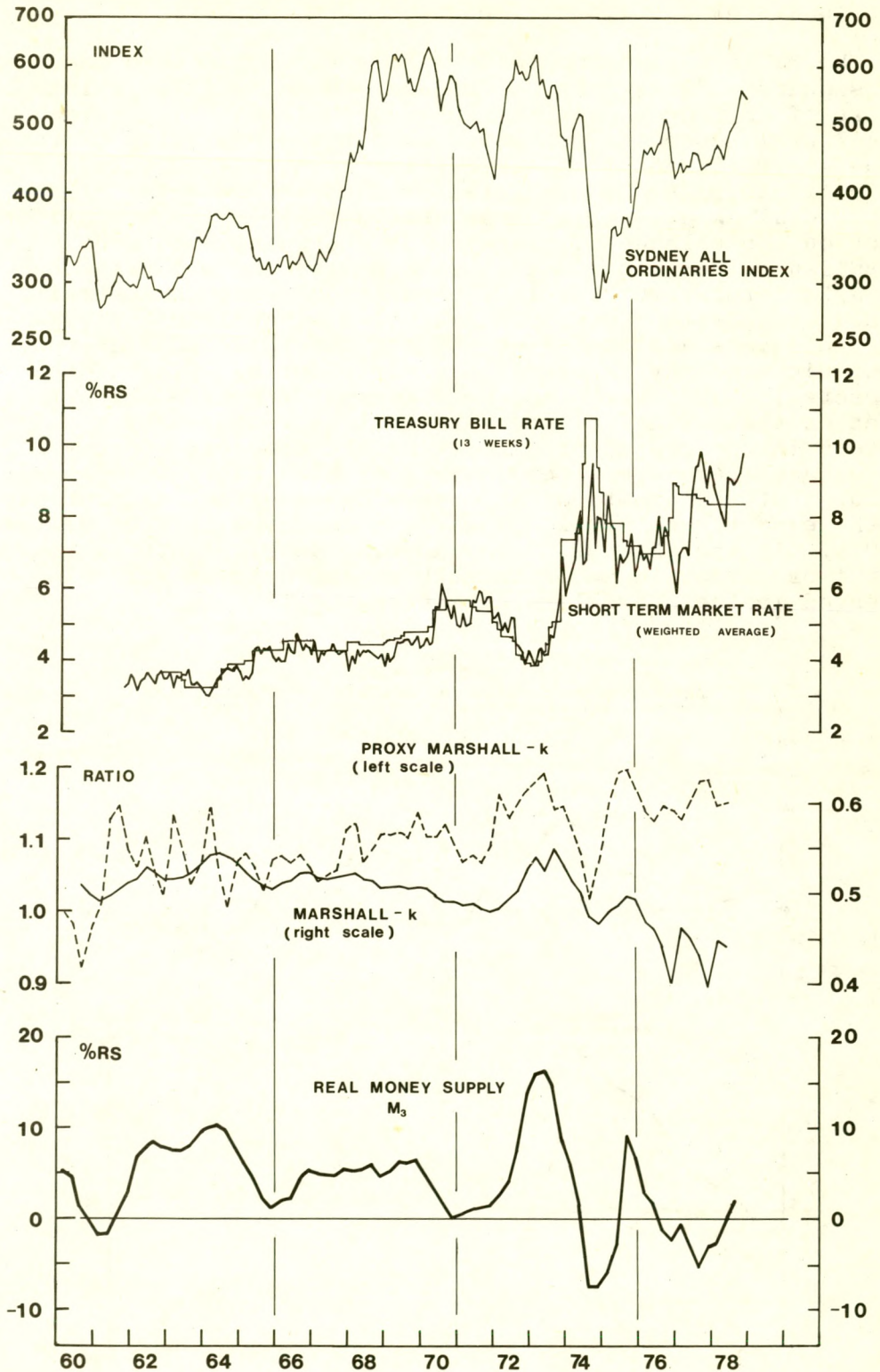


*Change of data series.

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AUSTRALIA

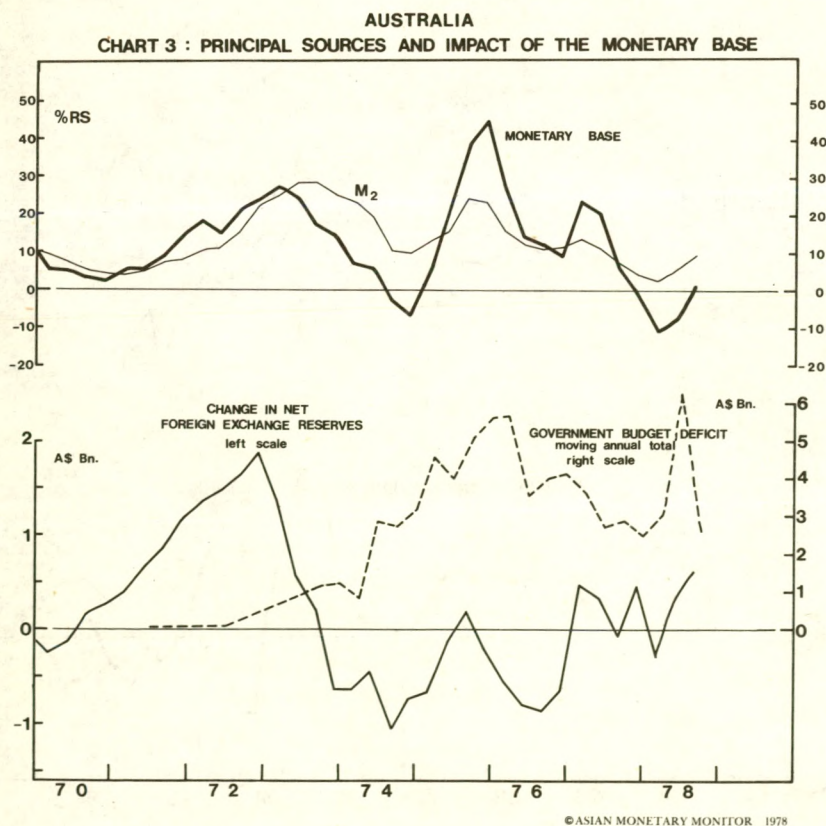
CHART 2 : THE STOCKMARKET AND LIQUIDITY INDICATORS



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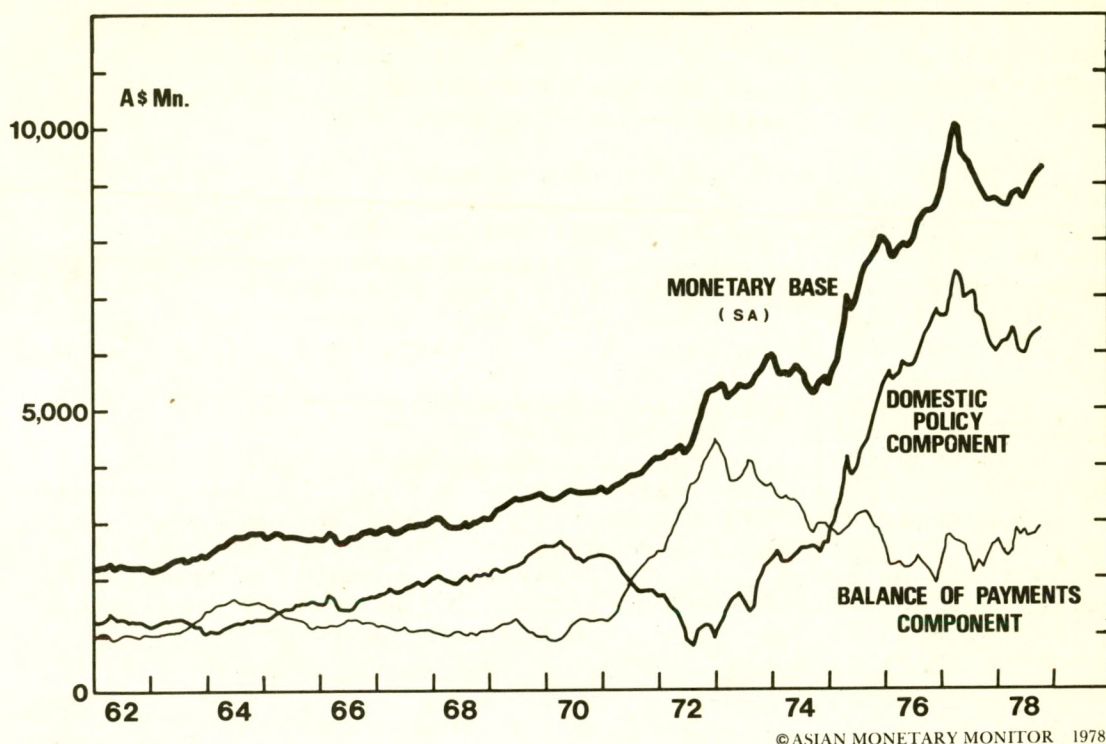
growing at an annualized rate of 12% per annum - is overshooting the target range of 6-8%. To attempt to forecast whether this trend will continue we examine in turn each of the three determinants of the monetary base.

The balance of payments is likely to continue to exert an expansionary influence on the monetary base in 1979, mainly because of an improvement in the trade balance. The Bureau of Agricultural Economics estimates that the gross value of farm production will rise from A\$6.9 billion in 1977/78 to A\$8.2 billion in 1978/79. Since rural produce accounts for around 43% of total exports this bumper harvest will have a considerable effect on the balance of trade. The depreciation of the Australian dollar along with the US dollar has also improved Australia's relative competitive position. Though Australia's competitive position has been improving since late 1977, the inevitable lags and the effect of the severe drought on rural output hindered any recovery in exports during 1978 but the prospects for 1979 are a lot more rosy. Of course the net effect on the balance of payments will be tempered by a recovery in the growth of imports as the domestic economy revives and there are already signs of a recovery in consumer demand. But the growth of imports will nevertheless probably lag the export recovery leading to an improved balance of trade in 1979. In the absence of any adverse developments in the capital or invisible accounts such an improvement will also be reflected in the overall balance of payments.



AUSTRALIA

CHART 4 : MONETARY BASE AND COMPONENTS



The second major factor affecting the monetary base is federal fiscal policy. In the 1978/79 budget announced in August some contraction of the deficit was projected, so fiscal policy will be no more expansionary than in 1977/78. Even so it should be noted that the Reserve Bank itself in its Annual Report of 30 June 1978 observed: "The task for monetary policy of moderating the potential monetary stimulus from the Commonwealth's deficit appeared formidable (in 1976/77)" and monetary restraint was achieved largely because of the balance of payments deficit and large sales of government securities to the private sector. In other words, even though the budget deficit will be lower than last year, it will still have a strong expansionary effect on the monetary base.

With both the balance of trade and the budget deficit likely to have expansionary effects in 1979, the third determinant of the monetary base - central bank policy - must adopt a deflationary strategy if it wishes to keep monetary growth within its target range. This it can achieve mainly by large scale government bond sales to the non-bank private sector. In 1977/78 these sales were facilitated by private sector expectations of declining yields, but as the Reserve Bank itself has noted such views about security yields can change quickly. After at least nine months of accelerating monetary growth, expectations of declining inflation rates are evaporating rapidly and further reductions in long bond rates look less and less justified. At the same time rising yields in the U.S. are casting a shadow over the A\$ markets. Since

the A\$ is closely aligned with the US\$, A\$ interest rates probably cannot move too far out of line with US rates without choking off the capital inflow on the balance of payments. Against this background the Reserve Bank must continue to offer relatively attractive (i.e. high) rates on government bonds in order to maintain sales to the non-bank public. There are already signs of a plateau in rates developing.

From the actions and statements made by the Reserve Bank and the government over the past two years it is difficult to believe that the authorities will abandon their monetary control and the fight against inflation merely to keep interest rates down. Interest rates will probably therefore either stabilize or rise in the next six months as the authorities move to restrain the growth in the monetary base.

Such a tightening of liquidity would eventually affect the stockmarket making the future course of the 1978 bull market in equities uncertain even though the gradual recovery in the domestic economy and the agricultural sector in particular will become more apparent in the months to come. Though some sacrifice of short run performance in the stockmarket and the economy may be necessary, the pursuit of a stable monetary policy must eventually pay dividends in the form of falling inflation and interest rates and a steady improvement in economic activity.

HONG KONG

OFFICIAL ACTION AND BANK REACTION

Sometime between 30th September and 31st October 1978 191 million Hong Kong dollars disappeared from the banking system. We don't know how, we don't know when, but it went. The subsequent weeks were perhaps some of the stormiest in the financial history of the colony. The precipitous collapse of the stockmarket, the rumours of an impending collapse in the property market, and widespread speculation about the financial health of one of the leading finance companies all contributed to making November a month of unusual excitement even by Hong Kong standards.

Unravelling the tangled skein of events in October and November must preforce rely heavily on assumptions unsubstantiated by statistics. No record of official actions is published and the banking statistics remain hopelessly inadequate and inappropriate for the task. Nevertheless a few intelligent guesses based on the crumbs of available information may not be too wide of the mark.

Since late 1977 the acceleration in monetary growth has been paralleled by a weakening in the Hong Kong dollar exchange rate. At first welcomed as a chance for Hong Kong exporters to improve their competitiveness the fall in the currency continued until after May 1978 its effective trade-weighted index was depreciating by around 2% per month.

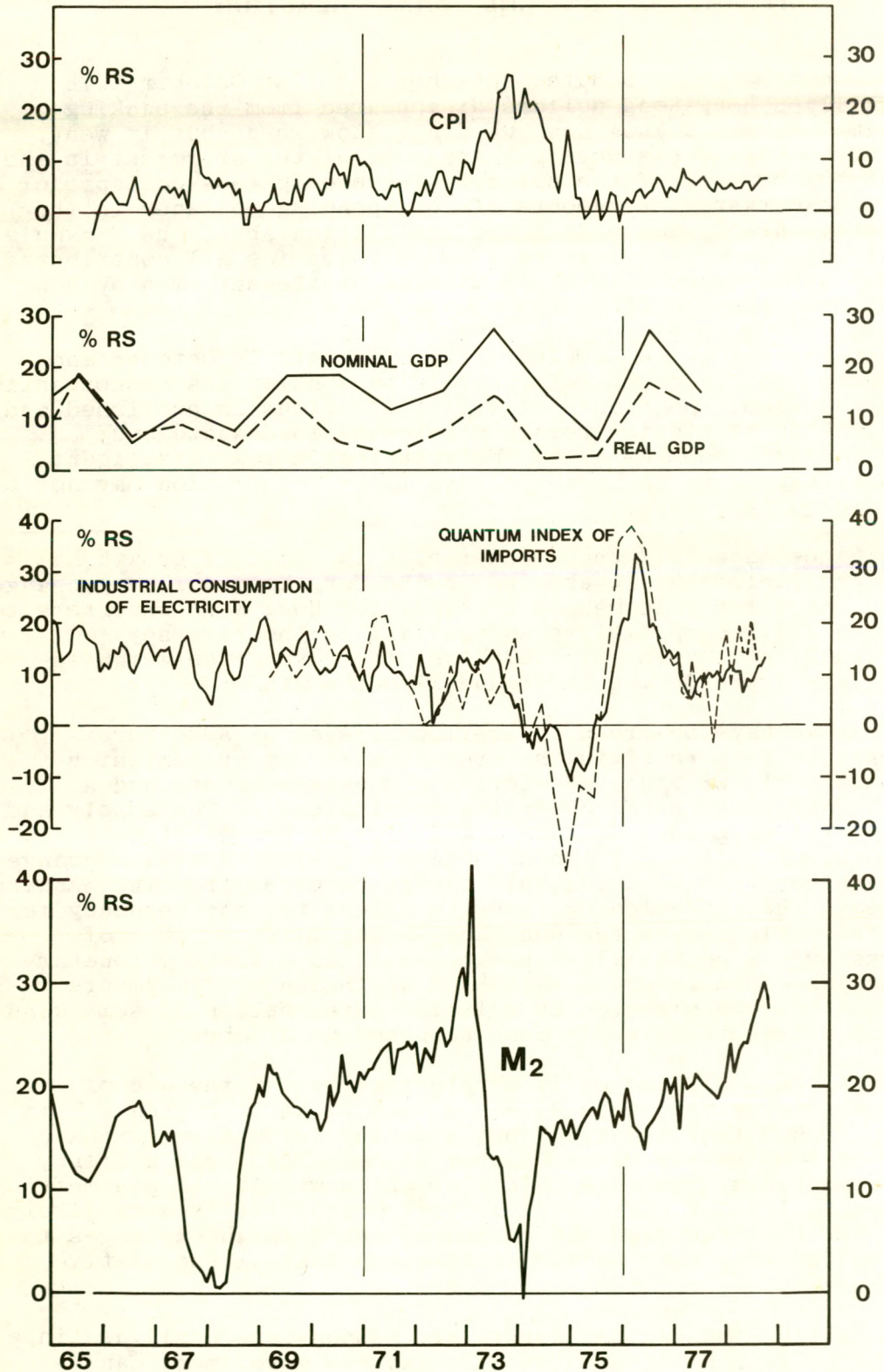
As we have observed in previous issues of AMM there appears to be nothing in the present monetary system which automatically prevents accelerating monetary growth and a falling exchange rate continuing indefinitely. The supply and demand for Hong Kong dollars can always be brought into equilibrium on the foreign exchanges by a fall in the exchange rate rather than by a loss of foreign reserves from the banking system. The retention of reserves alleviates any tendency for credit to tighten in the Hong Kong money markets. Now of course such a potentially unstable situation whereby monetary expansion can accelerate unchecked by 'balance of payments effects' may be arrested by official intervention of some kind and this is very probably what happened in October.

Not only did the money supply figures for the end of September show that both M_1 and M_2 had risen more than 30% in the previous twelve months, but also the 'effective' exchange rate fell by nearly 5% in October alone. The local currency was even weaker than the US dollar which was itself plummeting against all major currencies in that month. It is very likely that the Exchange Fund intervened on the foreign exchanges to defend the Hong Kong dollar against substantial speculative pressure.

As the Financial Secretary Mr. Haddon-Cave explained in a speech on 16th November, the only way the government can

HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



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influence the growth of the money supply is through its transactions in the foreign exchange market. However, the government's influence even in that area is imprecise and uncertain. It is by no means clear that intervention to support the Hong Kong dollar would have caused a contraction in the money supply.

The Impact of the Exchange Fund on the Money Supply

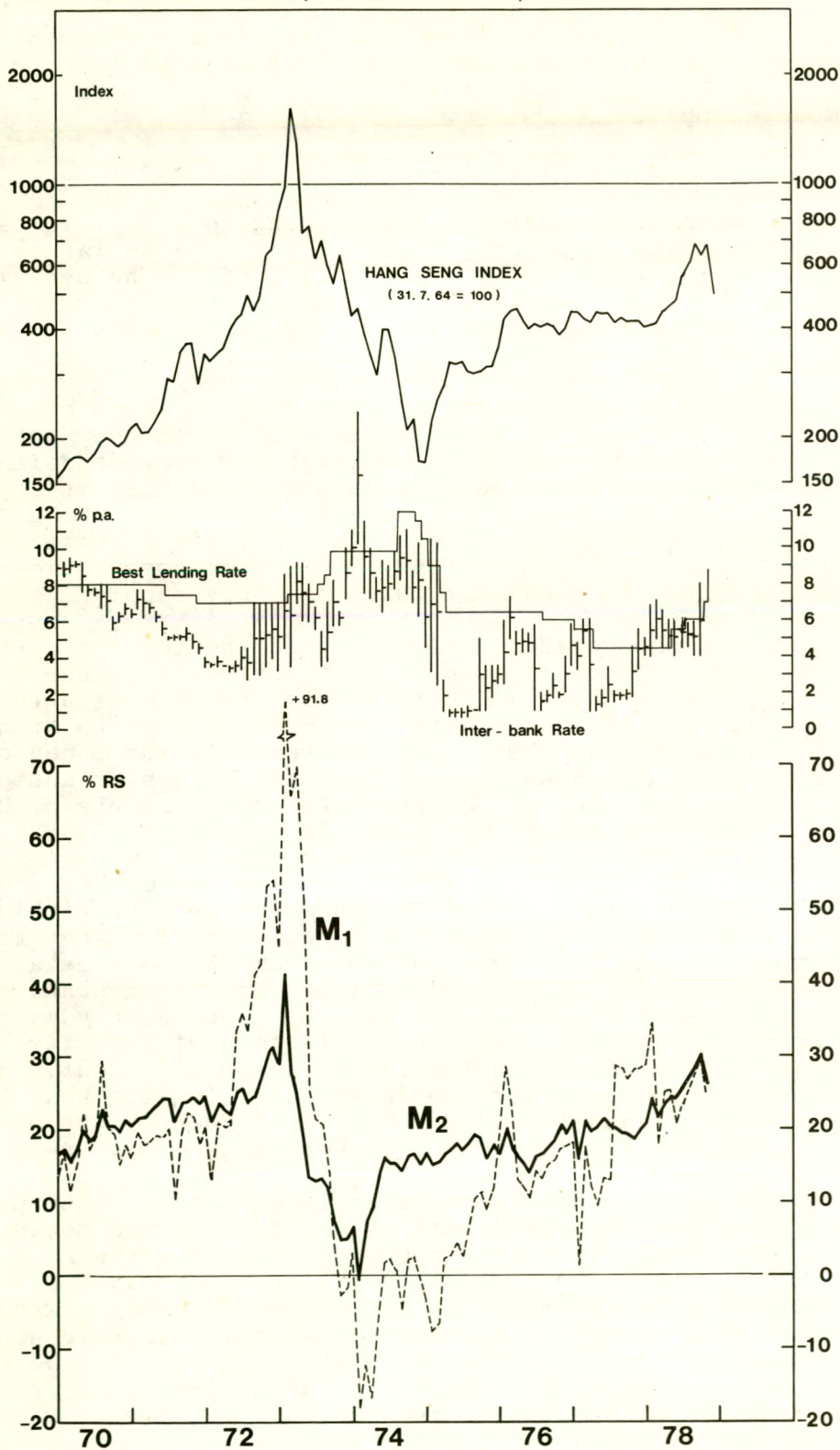
The Exchange Fund in purchasing Hong Kong dollars is in effect exchanging with the private sector a US dollar or foreign deposit for a local currency deposit. The overall effect on the money supply depends on whether either the Exchange Fund or the private sector chooses to hold the foreign currency deposit at a Hong Kong bank. (The Hong Kong dollar deposit being defined as a liability of a Hong Kong Bank always remains within the domestic banking system.) There are four cases to consider: if in being transferred from the Exchange Fund to the private sector, the foreign currency deposit is transferred from a local bank to an off-shore bank it is no longer included in money supply statistics of Hong Kong and the money supply is reduced. Alternatively if the private sector purchaser of the foreign currency deposit chooses to keep it at a Hong Kong bank it remains within the money supply.

If the Exchange Fund initially held the foreign currency deposit overseas then if when it is transferred to the private sector it remains overseas there is also no change in the money supply. Finally if the private purchaser chooses to transfer it to a domestic bank there is an increase in the money supply. Thus supporting the Hong Kong dollar can have an expansionary, contractionary or neutral effect on the money supply of Hong Kong.

This peculiar state of affairs has arisen because the Hong Kong dollars purchased by the Exchange Fund remain within the banking system. If, like a central bank, the Exchange Fund could withdraw the Hong Kong dollars from the commercial banks, it would reduce the reserve base of the Hong Kong banking system which in turn would restrain the money supply with much greater certainty by a multiple contraction of deposits in the usual way. As it is the authorities cannot confidently predict the effect of foreign exchange intervention on the Hong Kong money supply, because they cannot control whether the private sector holds its foreign assets in Hong Kong or overseas.

It may well be that government intervention to support the Hong Kong dollar did contribute to the fall in the money supply. Voluntary action by commercial banks perhaps in response to government pressure may also have played a part in supporting the Hongkong dollar and causing a decline in the liquid foreign assets of the banking system. As evidence, albeit tenuous, it is worth noting that the net lending (i.e. lending minus borrowing) to foreign banks by the commercial banks declined by 58% during the month of October.

HONG KONG
 CHART 2 : MONEY, INTEREST RATES, AND STOCK PRICES



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The Impact of Other Government Transactions on the Money Supply

Despite the Financial Secretary's assertion that the only way the government can affect the money supply is through the Exchange Fund, it has recently been suggested that the government could reduce inflationary pressures by cutting back its spending, presumably allowing its revenue to outgrow its expenditures. However, given the unusual banking structure in Hong Kong, a move towards a budget surplus of this kind is not necessarily deflationary. On the contrary, in the absence of any other specified changes, the effect could well be expansionary and therefore inflationary, not deflationary.

The reason is that in all of its transactions on Fiscal Account the Hong Kong Government is in exactly the same position as an individual or corporate business entity. It maintains its account at the Hong Kong and Shanghai Bank, so that transfers to its account must either come from other depositors within the banking system or from abroad. Conversely, transfers from its account must be in favour of other local depositors or in favour of other parties overseas. If we confine ourselves to domestic transactions and we assume - as is surely reasonable - that the public maintains a higher cash currency-to-deposit ratio than the government, the immediate effect of an increase in the government surplus (and a corresponding reduction in private deposits) will be a temporary excess of cash currency in the hands of the public relative to their deposits. As the private sector attempts to reduce its desired cash-to-deposit ratio there will be an increase in deposits, and a resulting increase in the total money supply.

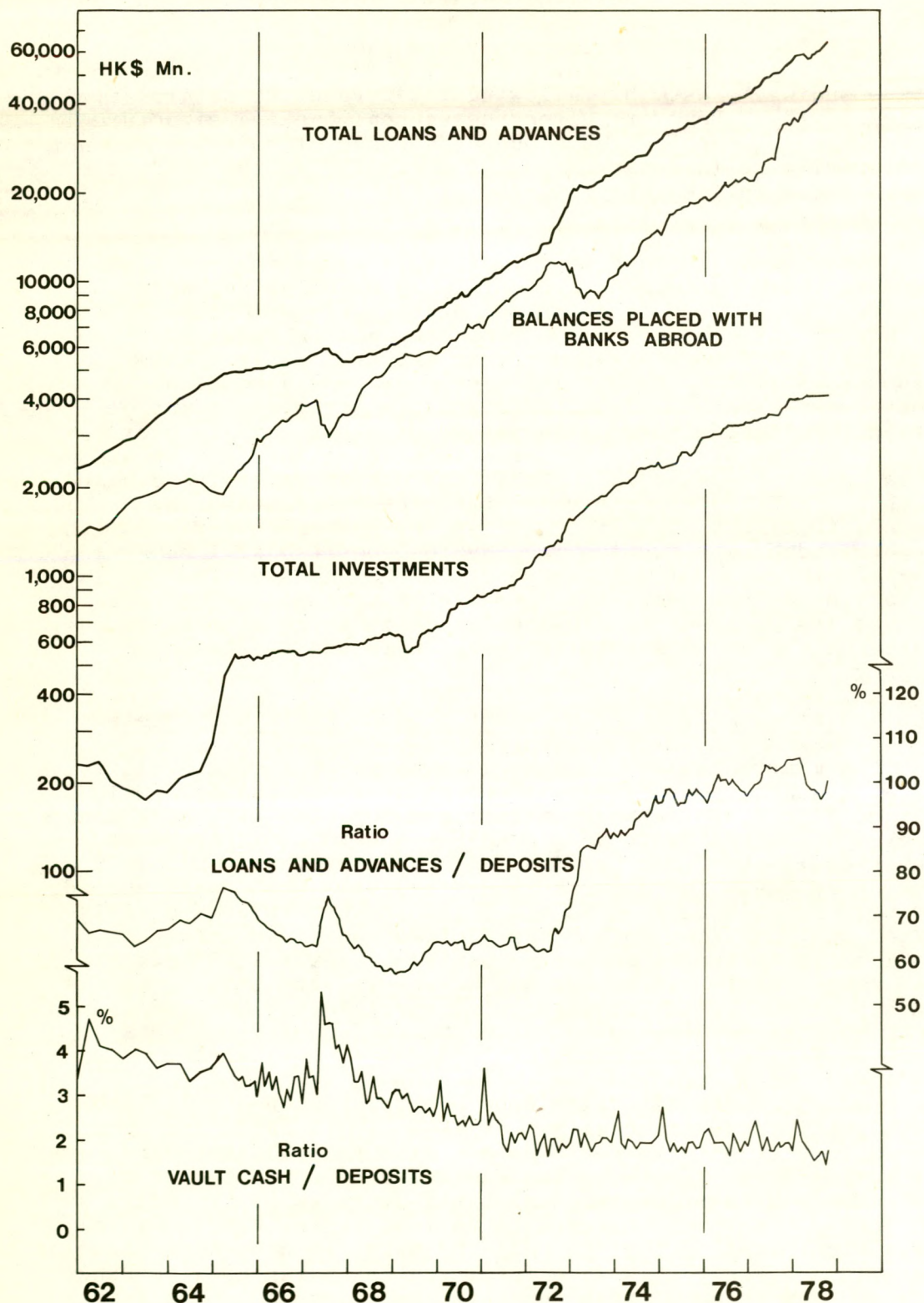
The Impact of a Decline in Deposits on Bank Balance Sheets

As Chart 3 shows, Hong Kong banks maintained a steadily growing quantity of funds with banks overseas until late 1972. In addition, foreign banks maintained deposits with Hong Kong banks. On a net basis Hong Kong banks were net lenders to banks overseas. (See Chart 4.) Then, starting in mid-1972 Hong Kong banks ran down their net deposits with banks abroad, briefly rebuilding them in the period August 1973-March 1974. After the Hong Kong dollar was floated there was a further decline in their net deposits, until by August 1975 Hong Kong banks as a whole had become net borrowers from banks overseas. This position was maintained until April 1978, when once again Hong Kong banks started to build up net deposits overseas. Once again they had become net lenders.

If total deposits with Hong Kong banks owned by the non-bank public suddenly decline, as they did in 1967, and again in late 1972, but the banks do not wish to call in their loans or investments, they must finance the difference either by running down their deposits at banks overseas or by additional borrowing from banks overseas. As long as the HK\$ was firmly pegged to sterling (or the US\$) the banks in Hong Kong faced no material currency risk in maintaining net balances with banks abroad, and because these deposits qualified as liquid assets for the 15% minimum liquidity ratio, there was even some

HONG KONG

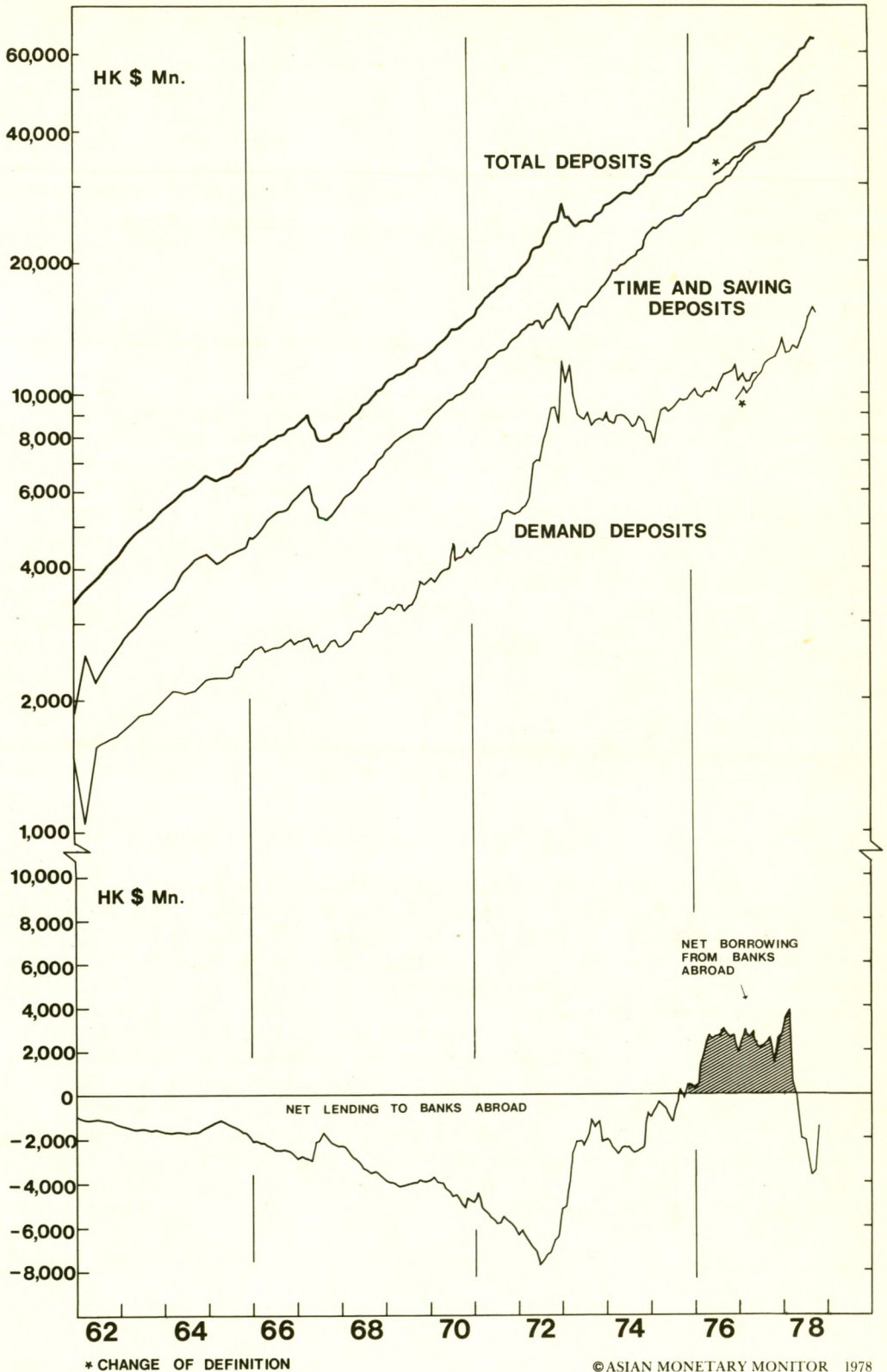
CHART 3 : BANK ASSETS



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HONG KONG

CHART 4 : BANK LIABILITIES



incentive to maintain such balances. But since the HK\$ was floated in November 1974 the risk of currency losses involved in maintaining net 'open' positions has obviously increased, so that compared with the period before November 1974 net lending to or net borrowing from banks abroad has now markedly decreased as a proportion of total bank assets or liabilities. Compared to total deposits, for example, net lending to banks overseas declined from 35.6% in June 1972 to around 8% in mid-1974, and averaged only 1.5% in 1975. Since then neither net lending to nor net borrowing from banks abroad has exceeded 7.5%. Other things being equal, under a floating exchange rate the Hong Kong banks will tend to be net lenders to banks overseas only when they believe the HK\$ will be weak, and they will tend to be net borrowers from banks abroad when they believe the HK\$ will be strong. On this analysis it would appear that Hong Kong bankers were generally bulls of the HK\$ between mid-1975 and early 1978, but since April 1978 they have been bears of the currency.

Accordingly, when non-bank deposits declined during October 1978, Hong Kong banks found themselves with net deposits at banks overseas, and were therefore able to choose between borrowing more from or running down their existing deposits with banks abroad. In the face of continuing strong domestic demand for loans in Hong Kong at the going rates of interest the banks

- i) increased their loans and advances
- ii) added to their investments

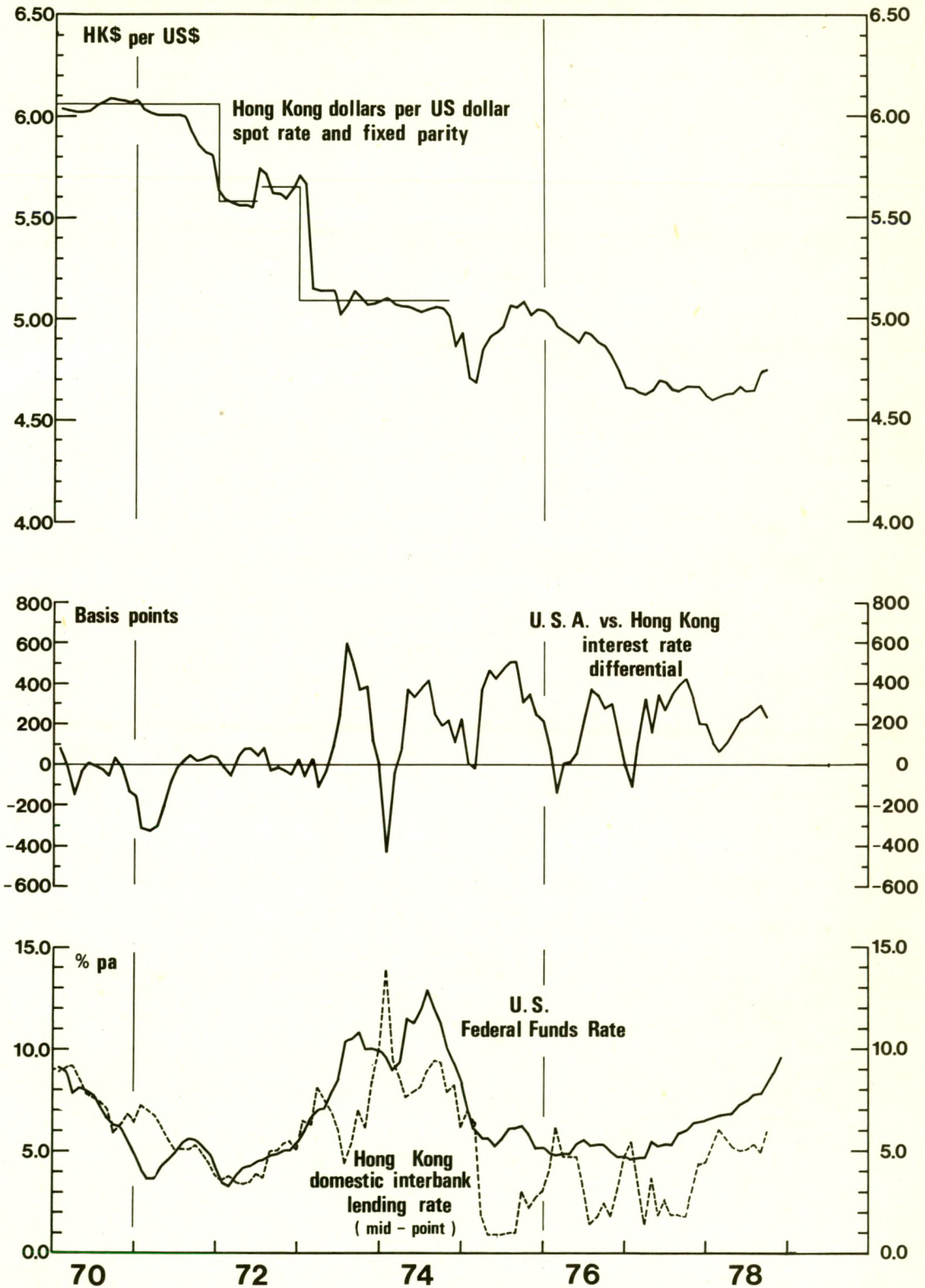
and met the decline in their deposits by

- iii) borrowing an additional HK\$2,065 million (net) from banks abroad.

FORECAST: If the Hong Kong authorities intervene in the foreign exchange market to keep the HK\$ at some predetermined parity vis-a-vis the US\$, or even within some fairly broad range, interest rates in Hong Kong will rise in line with rates in the United States. But given the recent background of excess monetary growth in Hong Kong, unless the authorities do intervene to peg the rate a further rise in interest rates is a minimum condition necessary to maintain the current exchange rate. Since we cannot be confident that there is any precise or adequate deflationary mechanism to reduce the growth of the monetary liabilities of the banks, price inflation in Hong Kong is likely to continue for a considerable number of months. In the more immediate future, the next few months will be highly risky for investment because of the potential for government shocks to the system, a tightening credit squeeze, and a developing crack in the property market. In the longer term

HONG KONG

CHART 5 : RELATIVE INTEREST RATES AND EXCHANGE RATES



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the prospect of price stability in Hong Kong and stability on Hong Kong's foreign exchange market is remote - certainly until after the U.S. has had a recession and the overseas demand for Hong Kong goods starts to rise more rapidly than domestic demand in Hong Kong. Against the background of the Fed's reluctance to impose a real squeeze in the U.S. and the uncontrolled monetary expansion in Hong Kong over the past two years, that prospect is barely a speck on the horizon at the present time.

JAPAN

A CYCLICAL PEAK IN THE TRADE BALANCE

In 1974 the Japanese authorities decided to abandon the policy of pegging the yen-dollar exchange rate and pursue instead a policy of stabilising domestic demand by combining a floating exchange rate with regulation of the money supply. In doing so they purchased domestic stability at the cost of exposing exporters and importers to increased instability. The implications of recent policy for the personal and corporate sectors were examined in the previous issue of AMM (Vol. 2 No. 5 pp. 8-14). In this issue we examine some of the implications of the floating yen-dollar rate for the exporting and importing sectors.

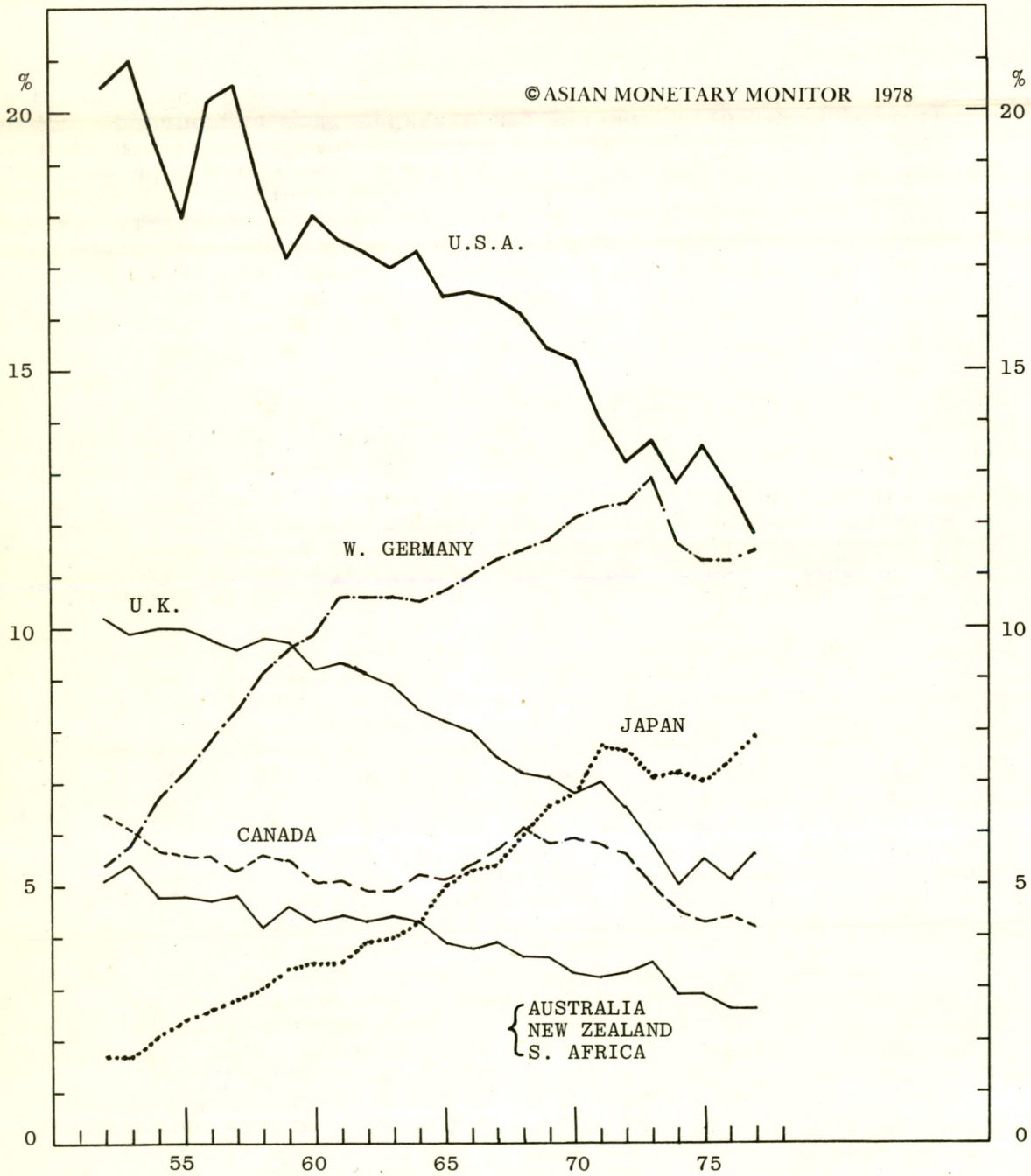
The Determinants of Exports

The demand for Japanese exports can be divided into three elements - secular, cyclical, and random factors. On a secular basis Japan's share of world exports has been growing, expanding from 1.7% of world exports in 1952 to 7.6% in 1972, falling temporarily back to 7.0% in 1975, and recovering to 7.9% in 1977. The relative performance of Japan in foreign markets is compared with that of other countries in Chart 1.

In contrast to Japan, the US share of world exports has been on a secular downward trend. In part this is because of the different starting positions of the two countries after the Second World War which gave the US an enormously greater capacity to supply the material needs of a war-devasted world. But since the trend of expansion and contraction in export shares has continued without much interruption - at least until the oil crisis of 1973-74 - this once-for-all explanation cannot be the whole story. Much of the explanation for the secular uptrend must be found in the continuing economic differences which characterise Japan and Germany on the one hand, and the US, UK, Canada and Australia on the other.

Over shorter periods Japan's exports exhibit quite wide fluctuations. How are these fluctuations determined? A monetary analysis of the demand for Japanese exports starts by regarding purchases by foreigners of Japanese goods as simply one component of their total spending on goods and services. Clearly, if Japan's share of world trade is growing, then the component of total spending devoted to expenditure on Japanese goods will be rising in a secular sense, but on a shorter term basis, the dominant influence on the rate of growth of Japanese exports would be fluctuations in the current total nominal income of foreigners. As Chart 2 shows, variations in the nominal GNP of three of Japan's large foreign markets (USA, W. Germany and the UK) appear to be closely correlated with fluctuations in the monetary growth experienced in those countries. In order to view this process from the standpoint of a Japanese exporter, money and income in those three countries have been expressed in yen terms, i.e. the command

PERCENTAGE SHARES OF WORLD TRADE CHART 1; EXPORTS



that foreign purchasing power has over Japanese goods.

Next, since Japanese products are only one part of total imports of those three major foreign markets, the total spending on imports of those countries is shown - again, in yen terms - and it appears to be reasonably well correlated with fluctuations in total spending. Finally, changes in Japan's exports in yen terms are superimposed on the overall pattern of import growth in the three foreign markets. It is evident that there is a close association between monetary growth in overseas countries at one end of the process and the behaviour of Japanese exports at the other end, and it appears that this mechanism operates primarily through the impact of money on total spending, and then in turn through the relationship between total spending and spending on imports.

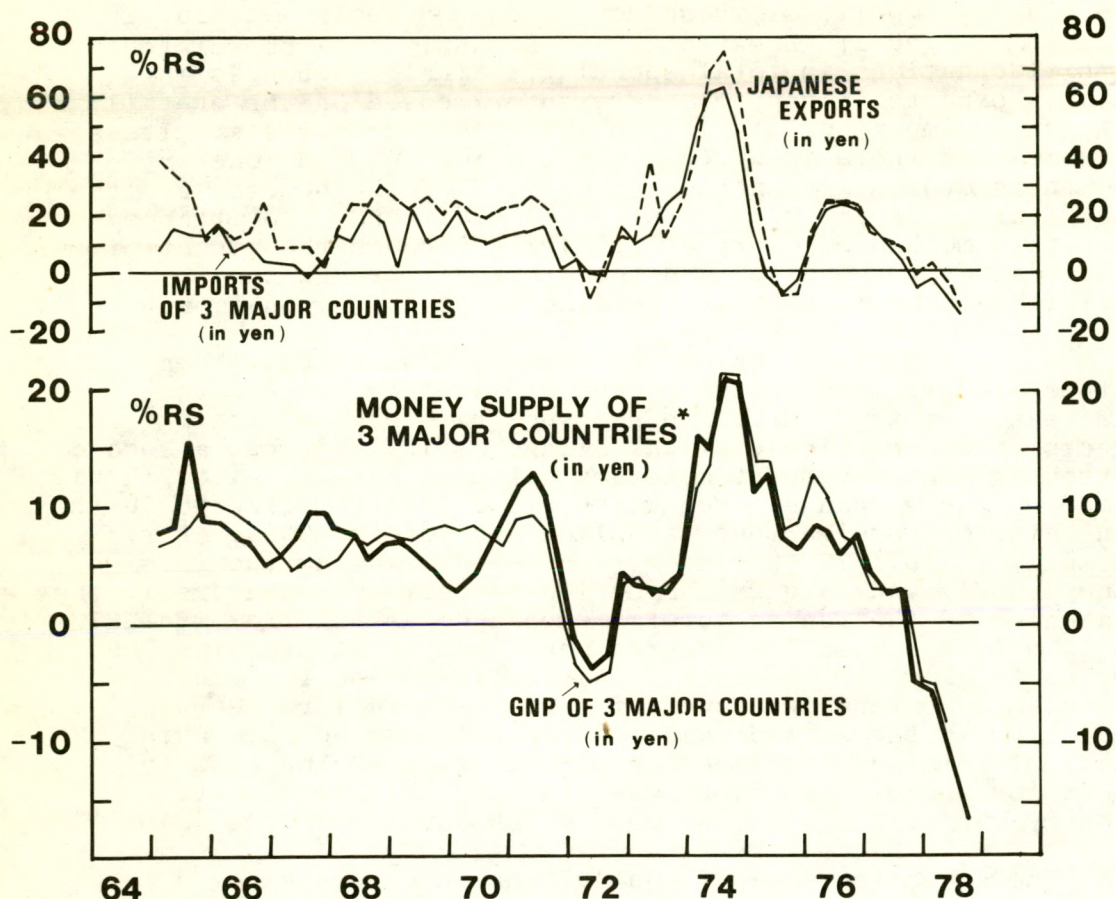
Since 1971 fluctuations in Japan's exports have been rather sharper than in the period of fixed exchange rates. One reason is that the fixed exchange rate regime itself precipitated the wide cyclical swings of 1971-74, but a second reason is that divergent monetary policies have resulted in big movements in exchange rates which are directly reflected in the yen value of foreign money supplies and foreign GNPs. For example, in 1971-72 the yen strengthened, causing the foreign money supply and foreign GNP series to decline. Conversely the weakening of the yen on foreign exchange markets from mid-1973 to late 1974 caused the foreign money supply and foreign GNP series to grow very sharply. In the first case the yen-denominated purchasing power of foreigners fell rather suddenly; in the second case the yen-denominated purchasing power of foreigners climbed very rapidly providing a useful boost to Japanese exporters when the rest of the domestic economy was sliding into a deep recession.

The situation in 1977 and 1978 has provided an even more dramatic example of this process in operation. Divergent monetary policies have resulted in wide currency movements which have in turn had an impact on the Japanese export sector. A relatively tight monetary policy in Japan contrasted with a relatively easy monetary policy in the USA (and to some extent in the UK) has been followed by a sharp upward movement of the yen, causing the yen-denominated purchasing power of foreigners to plummet. Along with that, the value of Japanese exports in yen terms has been decelerating since late 1976, and actually declining for most of 1978.

An important point to emphasise is that much of the recent sharp downswing is due to currency movement rather than to any drastic shift in foreign monetary policies. Therefore, although a casual glance at the chart might suggest that Japanese exports are due for an even sharper collapse following the 17 percent decline in yen-denominated foreign money supply, the prospective downturn for Japanese exports could be significantly modified by a reversal in the overvaluation of the Japanese currency. Nevertheless, it would appear that fluctuations in Japanese trade are much more volatile than fluctuations in the level of foreign purchasing power. In

JAPAN

CHART 2 : DETERMINANTS OF EXPORTS



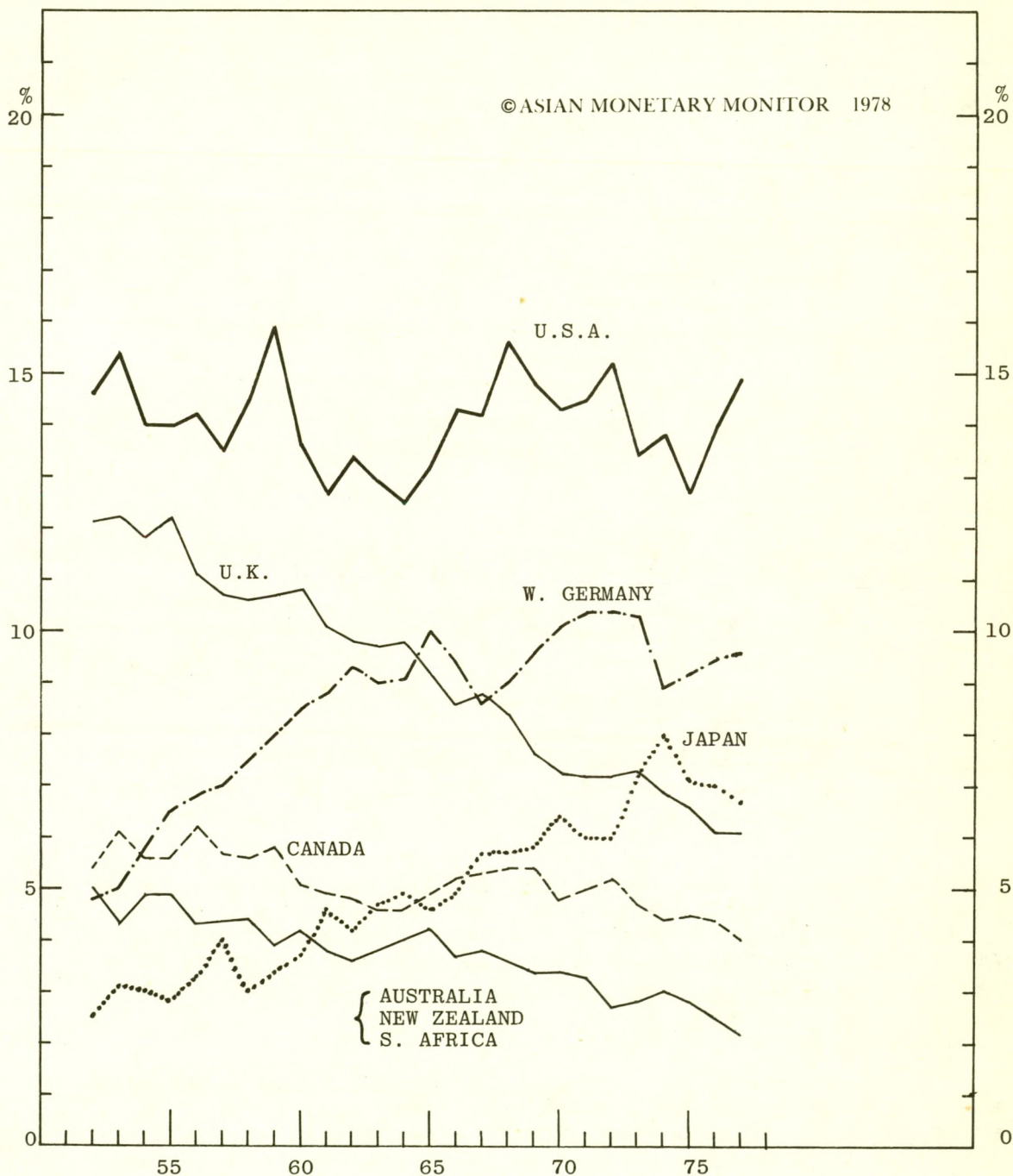
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1974, for instance, the 21 percent rise in yen-denominated foreign money supply was associated with a 75 percent upswing in yen exports. A 17 percent decline in yen-denominated foreign money supply in the third quarter of 1978, therefore, almost certainly spells a substantial further downturn in Japanese exports in 1979.

From a broader perspective, such a development would be both natural and desirable. Many of Japan's present-day export industries were built up when the external value of the yen was such that exporters' revenue was as much as 360 yen for each dollar of exports, whereas the current value of the yen yields them only about 190 yen for each dollar of exports. Naturally those industries no longer find it profitable to export - even assuming the remainder of their cost structure has not changed - and the capital that has been sunk in these ventures must be redeployed. But that process is necessarily slow. Physical capital often has an extraordinarily low value in alternative uses, and hardly any value as scrap so that in reality huge

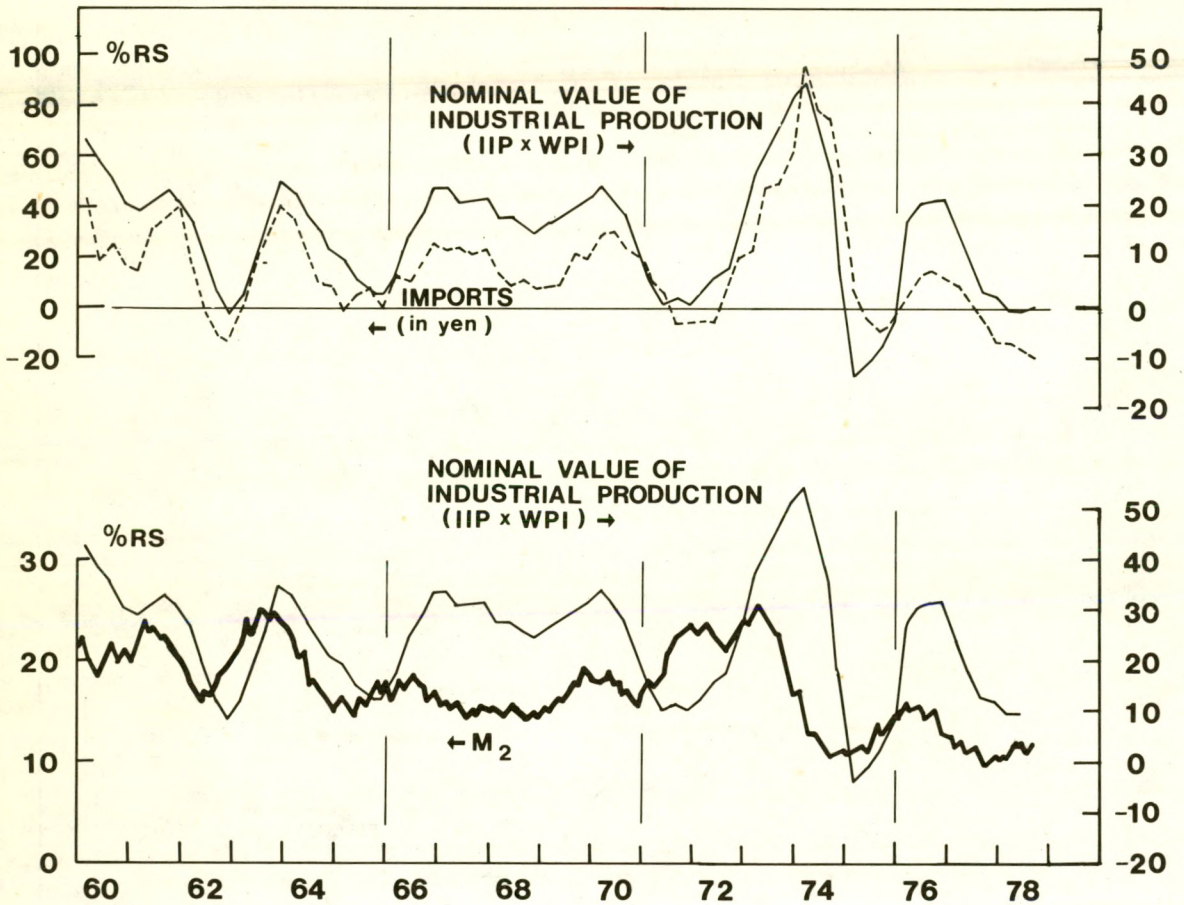
PERCENTAGE SHARES OF WORLD TRADE

CHART 3; IMPORTS



JAPAN

CHART 4 : DETERMINANTS OF IMPORTS



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amounts of assets must be written off and new capital must be raised before profitable ventures can be restarted. The decline in the yen-value of foreign purchasing power therefore has the desirable consequence of accelerating the restructuring of Japanese industry.

The Determinants of Imports

Japan's demand for imports on a secular basis paralleled the secular rise in its exports until the early 1970s. As shown in Chart 3 Japan's imports as a percentage of world trade rose from 2.5% in 1952 to 6.4% in 1970, and declined slightly to 6.0% in 1971-72 before rising to a peak of 8% in 1974. Subsequently the relatively low level of demand in Japan has been accompanied by a fall in Japan's share of world imports to 6.7% in 1977, while the shares of Germany and the United States have risen to 9.6% and 14.9% respectively. It is likely that the recent decline in Japan's share is a cyclical rather than a secular phenomenon, and that as the economy restructures itself

the growth of imports and exports will more nearly approximate one another.

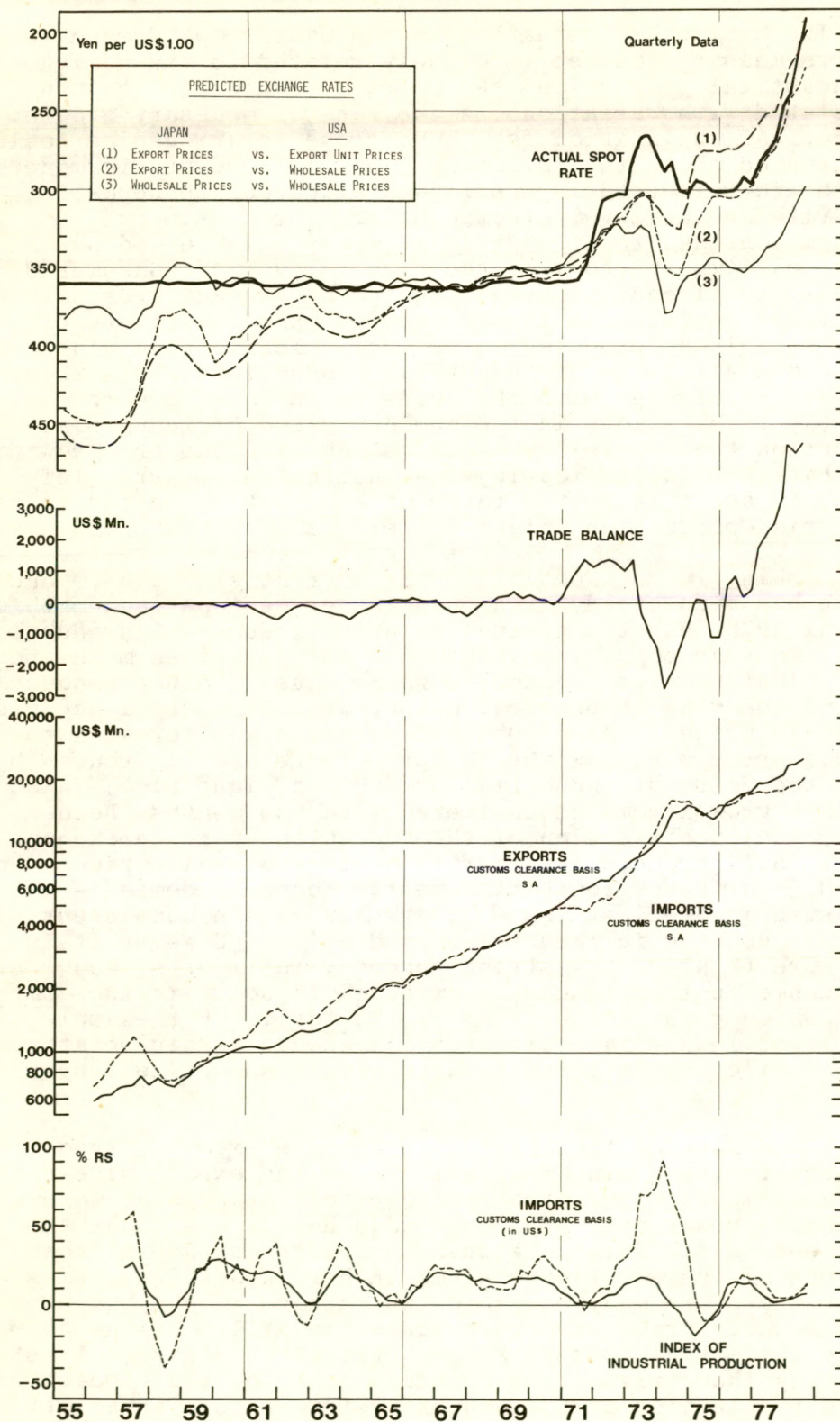
The cyclical fluctuation in the pattern of demand for imports measured in yen is closely related to the nominal value of industrial production (see Chart 4), which is in turn associated with variations in the rate of monetary growth. A theoretical explanation for these close relationships could be constructed along the following lines. Increases in monetary growth are reflected in a build-up of corporate deposits, and in a rise in the level of expenditures by consumers. Corporations use their additional money balances to purchase additional imports to meet the higher level of consumer demand, and also to finance plant and equipment expenditures to supply additional output. As in the case of exports, fluctuations of imports could be expected to be more volatile than fluctuations of the overall value of industrial production. This theoretical chain is consistent with the evidence in Chart 4 which shows that (a) fluctuations in the nominal value of industrial production tend to follow after changes in monetary growth, and (b) that the fluctuation in yen-denominated imports (left scale) is about twice the range of fluctuation in the value of industrial production (right scale).

Looking in more detail at the current situation, monetary growth has been steady at around 12 per cent per annum through most of 1978, but the nominal value of industrial production on a year-to-year comparison basis has not yet risen much above zero. In the third quarter it was up just 1.5 pct because most of the rise in physical output was offset by a decline in wholesale prices. As a result imports in yen terms in the third quarter were down by 20 pct. There are two routes by which the value of industrial production might rise - assuming monetary growth remains unaltered - in the months ahead. First, the stabilisation of the yen on the foreign exchange market could produce a firmer trend in wholesale prices, and second, continued growth of domestic consumer demand - as suggested in the last issue of AMM - would be consistent with a steady upswing in industrial production. However it is premature to predict a strong recovery in imports, and most of the change in imports can be expected to occur in the composition of imported goods rather than in the total. For example, imports of industrial raw materials should remain relatively static while manufactured imports should show a healthy rise.

FORECAST: Most of the changes in Japan's external trade accounts in the coming year will be on the export side rather than the import side. From the Japanese standpoint foreign purchasing power over Japanese goods has plummeted as the yen has risen on the foreign exchange markets and Japan faces the prospect of the worst-ever slump in her export industries. Of course there are many companies which have already adapted to the new world price structure and which will continue to be highly successful, but in some of the more traditional, staple exporting industries it is probable that the real impact of the upward revaluation of the yen has yet to become apparent.

JAPAN

CHART 5 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE

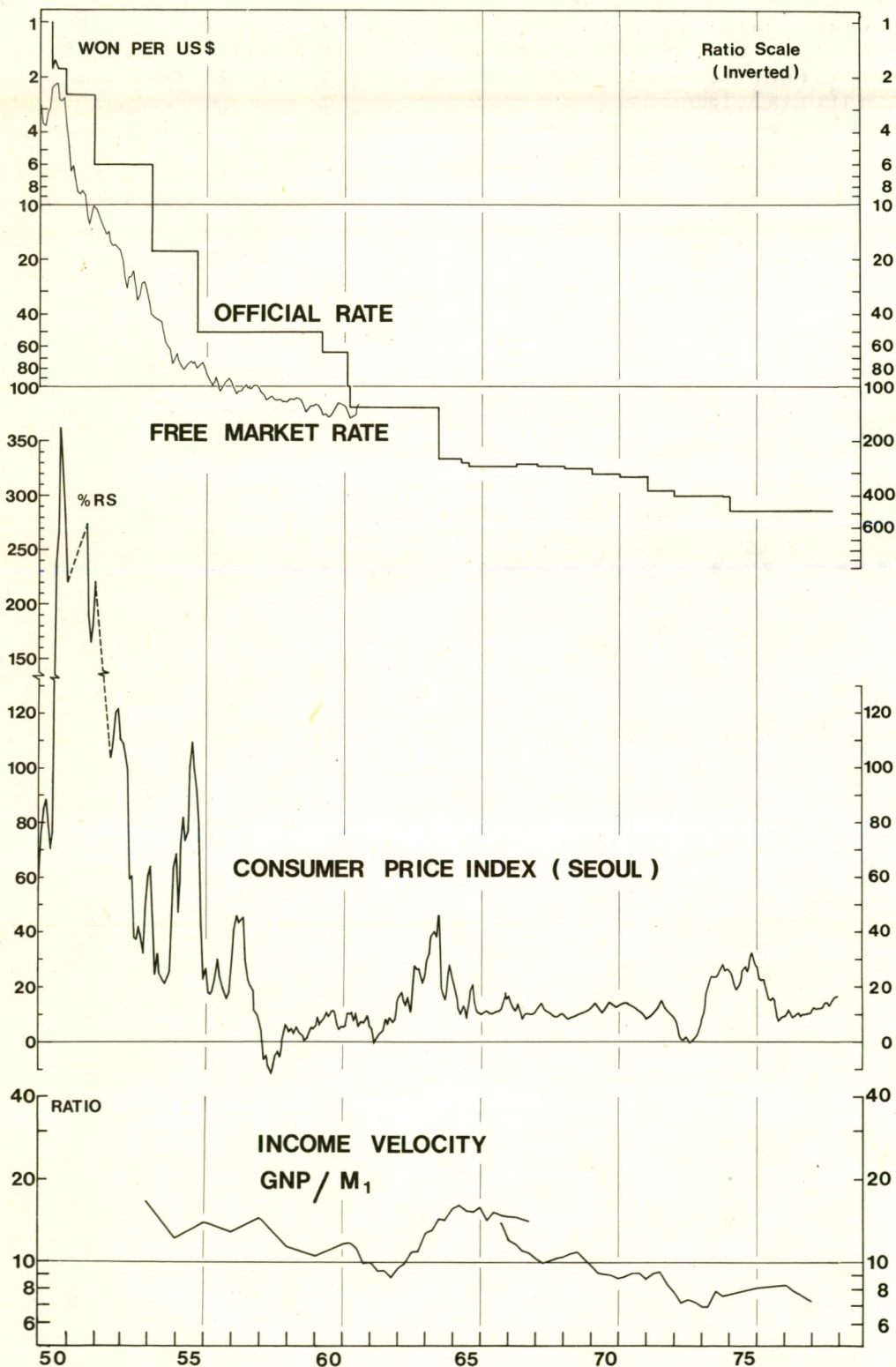


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Temporary government purchases of commodities or planes aside - essentially 'random' disturbances - the yen value of Japan's imports should not be expected to show any sudden rise. Nevertheless the closing of Japan's trade surplus could be (a) somewhat nearer at hand than one might otherwise suspect, and (b) largely due to the weakness of traditional Japanese export lines rather than any forthcoming upswing in her commodity and raw material imports.

SOUTH KOREA

CHART 1 : VELOCITY, PRICES, AND, EXCHANGE RATES



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KOREA

A ROLLER-COASTER IN FULL SWING

The Republic of Korea is one of several countries of the East Asia Pacific Rim to have maintained an exchange rate rigidly pegged to the US dollar since the early 1970s. During 1978 the distinctive feature of the Korean Won in contrast to other pegged exchange rates in the Far East was that it was neither revalued nor devalued. This article explores some of the consequences of having maintained the Won/US\$ rate at a fixed parity.

Unfortunately for South Korea the move to a more rigid exchange rate was made in the early 1970s just when the rest of the world was about to abandon pegged rates. Up until that time the economy had successfully adjusted to the outside world by means of a successive series of devaluations. (See Chart 1.) The long run consequence of the decision to peg is that the movement of the overall price level in Korea must now keep roughly in step with whatever price changes occur in the U.S.A., i.e. they must rise approximately 10% p.a. at the present time. By the standards that South Korea is used to an average inflation of the order of 10% p.a. would be a rather mild episode. However, in the shorter term the decision to peg the exchange rate has had side-effects which have caused the Korean economy to deviate sharply from any comfortable path parallel with the U.S.A. In theory the pegged exchange rate should have removed uncertainty and enhanced stability; in practice it has precipitated a short-lived boom followed by what promises to be a rather violent but temporary braking action in Korea's exuberant economic expansion.

Throughout 1977 Korea's foreign exchange reserves were rising. The background to this was a strong upturn in output, and especially exports, coupled with a rather modest growth of imports. The trade balance, which had recorded a record deficit of \$2,391.5 mn in 1974 progressively improved during the next three years.

Trade Balance (US\$ mn)

1974	-2,391.5
1975	-2,193.4
1976	-1,058.3
1977	-764.0

In the domestic economy industrial output continued to grow at around 20% per annum. So far so good. However, as the trade balance improved, balance of payments surpluses became a regular monthly occurrence, so that the deposit money banks were consistently converting foreign remittances into domestic Won currency on behalf of their customers. Their Won deposit accounts were accordingly credited - thanks to the official policy of maintaining a pegged rate - with 484.00 Won (less commissions etc.) for every dollar of such net remittances

received from overseas. With demand for exports remaining strong, particularly as the US dollar and the pegged Won depreciated together in late 1977 and early 1978, there was a steady build-up of Won balances at the banks: by February 1978 M_2 was up 45.3% over the preceding year. Correspondingly the domestic credits of the banks had expanded by 32.4% by February, and 38.1% by June 1978.

These rates were far in excess of the growth in real output of the economy, and yet these monetary assets still commanded extensive purchasing power: Prices had not yet risen. In conformity with a familiar pattern, holders of deposits began to purchase equities on the Seoul stock exchange and to bid for real estate in anticipation of capital gains. In addition businessmen naturally used their profits to increase expenditures on plant and equipment while consumers raised their expenditures on current goods and services.

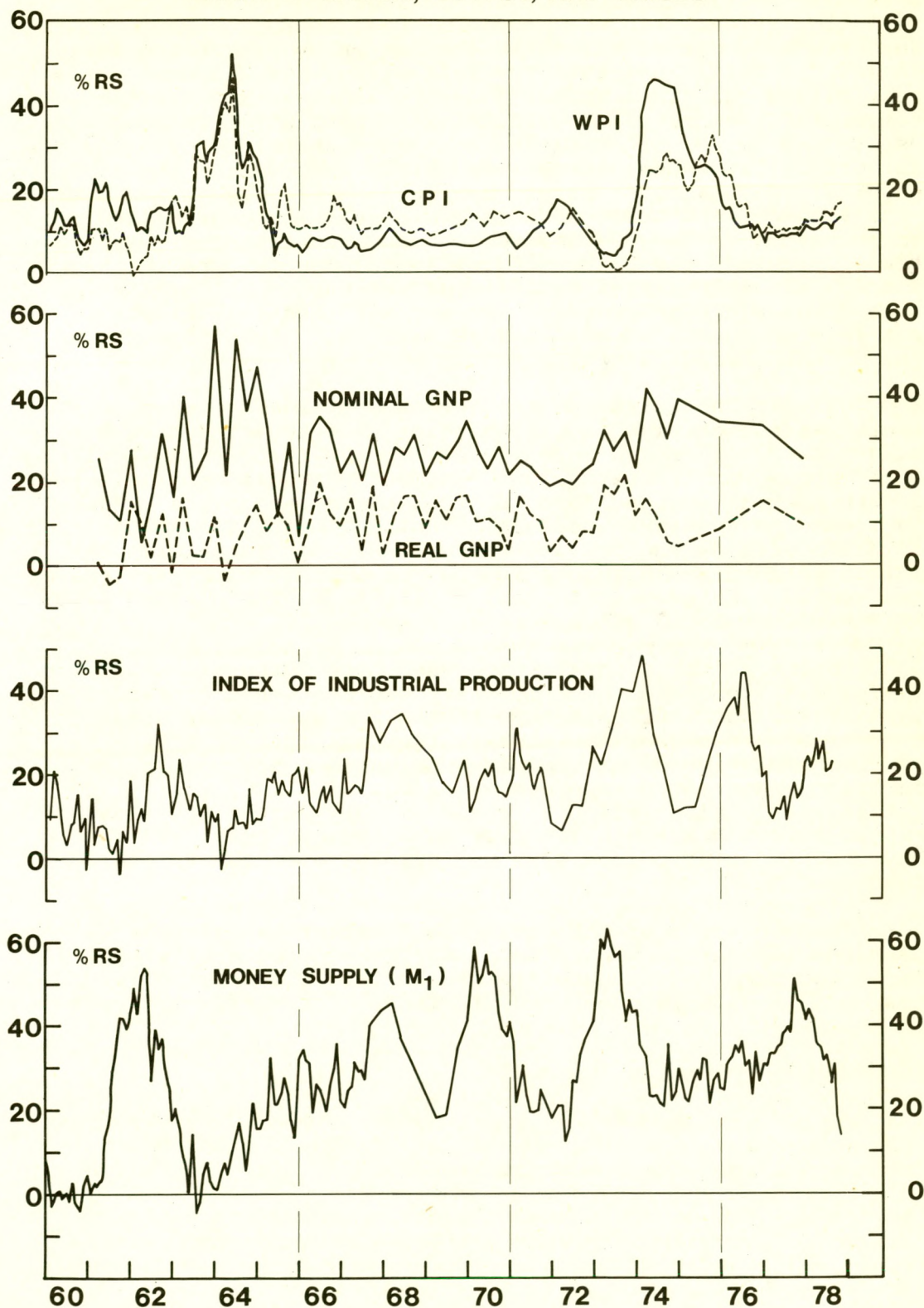
On the external side the accumulation of foreign exchange came to rather an abrupt halt. The success of the export drive continued to be impressive, but little by little the growth of imports and the failure of the capital accounts to maintain the same momentum resulted in a turnaround. Exports, having almost closed the gap with imports in 1977, began to slip behind again while imports moved ahead. Naturally this reversal led to net sales of Korean currency to the Bank of Korea to meet the net deficit, exerting a contractive influence on Korea's money supply. By the end of August M_2 had decelerated from 45.3 (in February) to 34.7 pct. If no other action had been taken from that moment the money supply would no doubt have slowed down somewhat further in the course of time until the expansionary momentum of the economy was trimmed back, and imports would have slowed in parallel. As a result monetary forces would soon be inducing a mild recession in the Korean economy through the balance of payments adjustment mechanism which, in time, would have corrected the overheating.

However, in modern economies natural forces are seldom allowed to work themselves out before the authorities step in to accelerate or retard the process. In the Korean case there was almost no intervention during the initial phase of the cycle. At the end of 1977 confident predictions were therefore made to the effect that monetary expansion would be restrained, that real growth would again be 10-11%, and that commodity price inflation would also be kept to 10%. But already M_1 had recorded 50.7% year-to-year growth in September 1977,¹ and M_2 was moving towards its peak of 45.3% in February 1978. (See Chart 2.)

What shocked the authorities into action was the discovery, early in the new year, that wholesale prices were rising at an annual rate of 18.2% in December 1977, 31.4% in January, and 23.9% in February. The consumer price index for all cities did not rise quite so sharply in December, but in January it rose at an annualised rate of 40.9%, 28.3% in February, and 16.8% in March.

Historically, as explained in our previous article on

SOUTH KOREA
CHART 2: MONEY, OUTPUT, AND PRICES



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Korea (AMM Vol. 2 No. 1), the Bank of Korea has used changes in Reserve Requirements as its primary instrument of monetary control. Following close on the news of the outbreak of inflation so early in the New Year, Reserve Requirements on Won deposits were raised three times in February, March and April. It was not until June that the Bank of Korea's discount rates were raised, and then rather suddenly along with all other commercial bank rates. Nevertheless, speculation in real estate and on the stock market continued unabated. In June the authorities addressed themselves to the symptoms of the problem: they banned further construction of large-sized single family homes, and there were moves to calm the overexcited mood on the stock exchange. However, no substantive steps were taken. Indeed, the Bank of Korea's additional loans to the commercial banks almost entirely offset the impact of the higher Reserve Requirements. As a result monetary growth (M_2) remained in excess of 38% on a year-to-year basis through the end of the second quarter.

Only in the third quarter were steps finally taken to rectify the excessive growth in money and credit, and then by direct rather than indirect means. In the first place ceilings were imposed on the extension of domestic credits to limit the growth of bank assets. Second, the government cut back sharply on its own expenditures and in so doing limited the acquisition of Won assets by the private sector.* In monetary terms the Korean authorities have slammed on the brakes: since the end of the second quarter year-to-year growth in M_1 has plunged from 32.2% in June to 13.4% in October.

So far as inflation is concerned, the authorities' action was already too late. The monetary explosion had continued too rapidly for too long. Through the spring and summer speculation in real estate and on the stock market was fuelled by the two-year accumulation of excess money balances. Nor was the rise in prices restricted to property or equities. Commodity and retail prices also reflected the boom. By August the index of export prices had risen 17% over the previous year, and in November consumer prices were up by 16.9% over their levels a year ago.

The behaviour of the Seoul stock market has already provided a study in microcosm of the consequences of stepping first too hard on the accelerator and then slamming on the brakes. In January the composite index opened at 469.7 and

*NB This is in contrast to the situation which arises in Hong Kong where reduced government expenditures for a given level of revenues do not automatically result in a reduction in the money supply. In Korea, as in Japan, the government maintains its accounts with the central bank so that any build-up of government deposits is matched by a reduction of commercial bank assets, whereas in Hong Kong government deposits are placed with an ordinary commercial bank (and count as part of the money supply) so that a transfer of deposits from the private sector to the government does not necessarily result in a corresponding decrease in commercial bank assets.

rose spectacularly to a peak of 648.4 on August 12. Since then the action has been almost all the other way. In October the index lost 85.6 points, the largest fall in absolute and percentage terms since the index was devised in 1972. In addition to the restrictive monetary policy, the stock market has been hit by a series of rights issues as well as by unfavourable tax legislation. (In summer the National Assembly reduced the tax advantages on dividends previously available to large shareholders.) Frustrated by the persistent slump in prices and the apparent unwillingness of the authorities to support the market, some 300 investors staged a demonstration on November 22 in front of the Korea Stock Exchange in downtown Seoul, demanding the temporary suspension of trading pending sweeping measures to stimulate market prices. Riot police were mobilized to prevent disgruntled shareholders from invading the floor of the exchange. Amidst the disturbances, the worst since the crises of 1962 and 1973, 294 issues closed down, 103 of them at the lowest limit permissible for the day.

FORECAST: Though the authorities have used moral suasion in an attempt to persuade institutional investors to support the depressed market, there are few signs of them relaxing their monetary squeeze, and as a consequence the effects must be expected to percolate from the financial markets to the real sector. For the time being therefore property and equity prices will remain vulnerable. The pace of the business expansion will slow, the upward pressure on prices will moderate, and the balance of payments will ultimately strengthen again. At that stage the cycle will repeat itself, starting with a monetary expansion induced by a renewed balance of payments surplus. Korea, in short, is experiencing the familiar stop-go cycle characteristic of Japan in the 1950s and early 1960s when the yen was pegged to the dollar at an arbitrary exchange rate. However, whereas in the 1950s and 1960s the United States pursued a restrained monetary policy, it has for most of the past three years been following a highly expansionary monetary policy which has caused its currency to depreciate, and this initially amplified the upswing in Korea's balance of payments surplus. If by now the United States had switched to a properly restrictive policy and the US\$ were to start appreciating, the consequences for Korea would probably be a painfully sharp downturn. As it is the US authorities have not yet squeezed very severely, and for their part the South Korean authorities are probably not willing merely to react passively to a deterioration in the balance of payments, so that the full impact of the transmission mechanism will not show itself at its most destructive. Nevertheless, the Korean roller-coaster is in full swing - the unintended but inevitable by-product of the move to a rigid exchange rate, just at the moment when unstable policies elsewhere in the world required a move in the opposite direction.

BOOK REVIEW

"How Japan Competes: A Verdict on 'Dumping' "
by G.C. Allen. Hobart Paper No. 81, published
by the Institute of Economic Affairs, London, 1978.

The question of what is 'fair' trade has no answer in economic theory. In practice the answer depends on who asks the question. The consumer of Japanese manufactured goods - no matter whether he is a Japanese or a foreigner - prefers a lower price, while the producers of such goods will prefer a higher price for their product. But is 'free' trade a truly realisable goal? Even the GATT (General Agreement on Tariffs and Trade), which seeks to relax the restrictions that impede international trade, demurs from the theoretical ideal. Its rules are intended to promote non-discriminatory policies, but it makes exceptions in favour of customs unions and historically recognised preferential economic relations. It tries to outlaw quantitative trade restrictions, but makes exceptions for countries with balance of payments troubles, for developing countries, for countries with agricultural support programmes... and so on.

Given the wide difference between the theoretical ideal and the practical realities, the question can only be asked subjectively and in relative terms: Are Japan's trading practices more ruthless or unfair than those of any other country? Prof. Allen's pamphlet attempts to provide a qualitative answer to this issue from the standpoint of consumers in Japan and in Britain. He begins reviewing the emergence of Japan as major exporting nation in the postwar era, emphasising that any focus on purely bilateral trade or payments balances is irrational, and by defining sporadic, persistent, and predatory dumping. His third chapter concentrates on defending Japan against the charge of persistent dumping. He concludes: "In the subsidisation of exports, Japan's recent record entitles her to claim that she is, if not blameless, less guilty than most of those countries which accuse her". Where dumping occurs it is usually a residue of trading practices of the 1950s and 1960s now largely discarded, and where financial subsidies persist they are small in relation to "the massive subsidies granted by the British Government to its shipbuilding industry." Correctly, in our opinion, the author points out that the chief reasons for Japan's competitive strength are to be found in its rapid rate of industrial productivity growth, the small size of the government sector by international standards, and the provision of a congenial environment for innovators.

On the import side, the question is again whether Japan discriminates against foreign importers more than other countries do. This chapter is much less satisfactory than the chapter on Japanese exporting, seeking as it does to explain Japan's "poor record as a customer for European manufactured goods." By the early 1970s most quantitative controls had been lifted, tariffs were moderate, and only such duties as the 68% ad valorem tax on Scotch Whisky, and the 35-40% protective duties on chocolate, biscuits and confectionary remained. The former is designed to protect the domestic industry, the latter are supposed to compensate for the extremely high domestic prices of grain and sugar which result from the protection accorded to Japanese agriculture. But who is to say that these restraints on trade are not exactly the kind of exception permitted by the GATT? Of course it is ultimately in the interests of the Japanese consumer to buy cheaper, higher quality products from abroad if he or she is allowed to, but is that 'fair' to the traditional Japanese producer or supplier? Allen's judgment is even-handed: "As history testifies, whenever a country outstrips others in industrial productivity, problems of adjustment are bound to appear. The rise in Japan's efficiency in manufacturing has faced not only Britain with costs of adjustment, but also Japan herself. There, certain industries such as textiles, which cannot match the high-technology industries in

performance, are in retreat. But a readiness to accept a continuous re-allocation of resources has been, and remains, a condition of material progress."

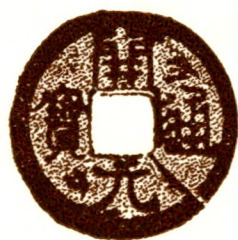
Impartial as this appraisal may be, it leaves out of account an important element of the overall adjustment problem. Several times in the book Allen explains how it is Japan's trade surpluses or current surpluses which have especially aroused hostility, antagonism, or protectionist measures abroad. Yet as he describes, since 1968 Japan's trade balance has fluctuated widely from surplus to deficit in 1973-74, and back to surplus again since 1975. The problem with Allen's analysis is that he deals essentially with secular matters only, leaving on one side the whole issue of whether or not wiser macroeconomic management in Japan or elsewhere might not have reduced the intensity of friction in bilateral trade relationships. For example he defends Japan's trade practices (and by implication the trade surplus) on the grounds that Japanese productivity has risen faster than productivity in the west. Similarly he maintains that restrictions on imports into Japan are not so much deliberate, discriminatory policy as a residue of an outmoded set of attitudes and practices. But a much stronger defence could be made.

As described in this issue of Asian Monetary Monitor, much of the fluctuation in Japan's trade balances can be explained by cyclical factors. In 1968-72 the relatively more expansionary policies of the U.S. compared with relatively restrictive policies in Japan contributed significantly to Japan's surpluses at that time. In 1973-74 the boom in Japan's domestic economy, itself resulting from the earlier pegging of the yen exchange rate and the monetary explosion which that policy generated, produced a huge increase in Japan's demand for imports, swinging the trade balance into deficit. Finally, since 1975 the relatively more expansionary policies pursued in Washington than in Tokyo led initially to a soaring demand for Japanese exports. Conversely, because Japanese policies since 1975 have been restrained, Japan's demand for imports has been weak, and hence the trade surplus.

Allen's analysis would have benefitted enormously by separating these cyclical problems from the secular issues. Public opinion in Europe and America, too, would be well served by being made aware of the extent to which the trade frictions between the U.S. and Japan (or the U.K. and Japan) have been aggravated by overexpansionary domestic policies. In the U.S., for example, by inflating the money supply the Fed created a boom in the demand for foreign goods, a boom which was sustainable only as long as the Fed continued with the policy and/or the dollar remained strong. Insofar as that goes, the cyclical element of Japan's trade surplus (and that of many other countries) was created by the U.S. authorities themselves. More objectively it resulted from the interaction of restraint in Japan with expansion in the U.S. Until the U.S. pursues a more sober monetary policy at home the solution of the longer term structural adjustment problems will be made more difficult by the appearance of frictions generated in the short term by mistaken cyclical policies.

The fact that Prof. Allen does not separate these two issues is certainly not due to any oversight, nor surely is it because he regards the cyclicity of the trade balance as unimportant. More probably his long career as a distinguished analyst of the Japanese economy has taught him the importance of the historical evolution of ideas and values in shaping policy in Japan. As he himself says, Japan is not a monolithic structure. But as an economic entity it is subject to certain natural forces inherent in the monetary and exchange rate policies adopted by different countries. This aspect of Japan's external relations requires emphasis because even though one might dispute Prof. Allen's view that in its trading practices Japan is on the whole no more sinned against than sinning, there can be no argument that in monetary terms, at least in the current cycle, Japan has been the saint and the U.S. has been the sinner. Nevertheless, public understanding of Japan's trading policies should be greatly enhanced by Prof. Allen's historical approach, and it is a great credit to the I.E.A. to have published yet another excellent Hobart Paper.

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